South East European Studies at Oxford

From Crisis to Recovery

Sustainable Growth in South East Europe

Edited by Othon Anastasakis, Jens Bastian and Max Watson

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It has been a pleasure to work with all the above individuals. We believe that this volume is a worthy contribution to the political economy of the region in that it deals constructively with a critical period in the region's development and future prospects. Needless to say, the views expressed here are in all cases those of the authors themselves and not necessarily those of the Bank of Greece or other supporting institutions.

The editors
January 2011

Introduction - Reform challenges and growth prospects in South East Europe

Othon Anastasakis and Max Watson

How should scholars read and policy-makers interpret the impact of the global crisis on South East Europe? What are the key lessons they should draw as the countries of the region begin to move on – appraising, adapting, and trying to keep up with their paths towards integration with the European Union? And how will the political dimensions of this process play out – both domestically and in terms of the EU accession anchor? These are the central questions that are explored in this collection of papers, in an effort to throw some light on the current economic experiences of South East European countries.

The chapters that follow provide many reminders that South East Europe is a highly varied region in terms of economic and political narratives, of reform progress during transition, and of policy capacity today. Across this diversity, nonetheless, a number of strong common themes emerge from the analysis presented here. These themes relate to policies during the run-up to the crisis; to lessons learned during the crisis itself; and to the challenges ahead in crafting more sustainable growth and EU integration strategies.

To the extent such shared lessons are accepted as valid, these papers could be seen as pointing towards a "revised consensus" on the kinds of economic policies that can deliver the 'rewards' (and avoid the pitfalls) of globalisation and Europeanisation, while minimising some of the risks and vulnerabilities experienced in recent years. One could even speak ambitiously of a "new policy paradigm" in the region: one that builds on, but does not replicate unthinkingly, the late 20th century Washington-Brussels Consensus.

This introduction serves in part to highlight such cross-cutting themes upfront, exploring experience with economic policy management during the run-up to the crisis, as well as the lessons learned and possible priorities for the future. Then it goes on to highlight some key questions about the political context for economic reforms. Can domestic constituencies for reform sufficiently underpin the strong policies that seem needed to navigate a safe course towards EU Accession and integration? And how much confidence can be attached to the EU enlargement (and the euro area) in the period ahead, as external anchors for a sustained policy effort in the region?

Economic Convergence Strategies and Crisis Experience

Country experiences across the region have been notably diverse over the past 20 years. Still, since the beginning of transition there has been a marked family resemblance among the reform strategies. To a significant degree, external drivers accounted for this. Reform priorities from the outset were shaped strongly from abroad based broadly on the Washington-Brussels consensus. Initially, most countries were following IMF-supported policy programmes as they grappled with the first generation problems of economic transition. Then, as time passed, the prospect of EU accession became an increasingly important anchor.

Reform priorities within this framework evolved over time in two ways. On the one hand countries moved at different speeds to dispense with IMF support and to come gradually under the aegis of the EU accession process and supervision: they thus shifted their reform emphasis to the transformative aspects of the *acquis communautaire*, which requires lasting changes to institutions and to structural policies. In addition, as experience with transition accumulated, the IMF itself came to place more emphasis on the development of institutions and regulatory frameworks (including notably in financial sector) as key flanking policies for liberalisation and macroeconomic stabilisation.

In the initial period of transition, more was achieved in terms of macroeconomic stabilisation and trade liberalisation than in terms of systemic transformation in the real economy. In South East Europe specifically, structural reforms lagged badly.

With macro-economic stabilisation, but slow structural progress, financial support for less competitive parts of the economy was mainly routed through quasi-fiscal channels such as policy-directed bank loans, distorted prices of energy and other inputs, misaligned exchange rates, or targeted write-offs of arrears in the enterprise sector.

The activation of these quasi-fiscal routes of support in South East Europe led over time to varying degrees of symbiosis between political elites and the management of state and socially-owned enterprises. Political groups derived influence and rents, while managers and employees in unreformed enterprises were protected from the full play of market forces. The result in extreme cases of near-hyper-inflation (such as former Yugoslavia and Bulgaria) was a hollowing out of the banking system and or a sharp rise in the public debt: it was impossible to maintain bank soundness and ultimately monetary control. Romania more than once came close to this abyss in the 1990s, but it repeatedly swerved aside at the 11^{th} hour.

These quasi-fiscal routes were an endemic problem of the region from the former Yugoslav states to Romania and Bulgaria, and in each case those who benefited from them managed successfully to block reform. So this was not so much a story of a weak state as a state hi-jacked by sectional economic interests. It was an environment that also provided the seed-bed for coalitions of interests that would conspire against any potentially decisively reformist state. And it was also a potentially fertile ground for corruption to take root.

This helps to clarify why the EU accession process has proved so difficult, yet so important, even as successful IMF programmes came and went. The importance of the EU accession process has been that it directly addresses the need for systemic change, including in such areas as competition policy, state aids, and public purchasing policy. This means that the EU anchor, by mandating deeper economic reforms, has also weakened the rent-seeking capacity of groups that conspired to maintain a weak state. A widely-held view is, however, that in Bulgaria and Romania this benign process is as yet incomplete.

The EU convergence philosophy also laid a strong emphasis on achieving and maintaining open capital accounts, thus promoting rapid financial integration between candidate countries and the existing member states. Twinned with strong systemic transformation, this held the promise of tapping a large pool of foreign savings to support productive investment and real convergence in South East Europe. However, in the presence of unbalanced and incomplete domestic reforms, it risked promoting a rapid expansion of sectors such as residential real estate and household consumption, without triggering the productivity gains needed to repay rising external debts. External liabilities grew rapidly, and the related domestic credit expansion typically included a high share of euro-denominated lending to unhedged domestic borrowers.

The confluence of these often conflicting factors triggered a typical profile of reforms across the region that was strong in terms of macroeconomic stabilisation, banking reform and financial integration with advanced EU economies, but less advanced in structural policies and particularly in the development of an attractive and dynamic business environment. Moreover, the pattern of relatively rapid financial integration but slow development of the traded goods sector left a problematic legacy in terms of crafting viable exit strategies that would assure more viable growth models for the future.

The accompanying chapters trace clearly and consistently the profile of these policy dilemmas. They record, in Susan Schadler's words, "a less than stellar growth performance since transition, and diagnose the home-grown factors that contributed to the susceptibility of the region's economies to adverse global influences". This lays a basis to evolve strategies for dealing with the post-crisis world and the new issues it will bring.

Stabilisation, but with insufficiently deep reforms

The years prior to the global crisis saw success in taming inflation across the region, as monetary anchors proved effective in most of the countries and headline fiscal deficits were brought down. However, as Kaoudis et al signal, "domestic policies were not sufficiently proactive. Measures to curb the exuberance of credit growth and asset prices in the upward phase of the business cycle did not prove effective".

Schadler underscores the lessons for policy management in this pre-crisis experience. On the one hand, she sees nothing to criticise in the broad growth model of the EU Accession countries, which she terms "super-integration" – referring to the strategy of convergence with open capital accounts and mobile labour. But she calls for a rethinking of the need for safety valves, such as prudent fiscal balances, and the full use of exchange rate flexibility, to mitigate the risks that build up during such rapid integration.

The role of capital inflows is a further key focus in this book where it is noted that South East Europe, like its transition neighbours to the north, relied to a far greater extent than Asian countries on foreign savings that entered their economies through capital inflows. Financial integration, including the prominent role of foreign-owned banks, was a crucial part of their transition strategy. However, the associated high investment levels during times of growth did not help much to improve the competitiveness of the countries.

Schadler sees one cause of this in the fact that South East Europe was late to switch to a more outward, trade-intensive convergence strategy, embracing it only with a considerable lag in most countries. It would be fair to add also that domestic reforms lagged in key areas for the business environment and for a healthy growth of the traded goods sector. EBRD Transition Indicators show substantial progress in stabilisation and banking reform in the run-up to the crisis, but a lagging performance in reforming the enterprise sector and in creating competitive domestic market conditions.

Broadly, these criticisms point to a problem of weak institutions in the region and a series of missed opportunities. As Schadler argues, integration through the EU helps convergence largely because it facilitates the flow of capital from high wage/high saving old members to lower wage/lower saving new members. However, if the volume of such flows is inhibited by poor institutions, she argues, this channel loses some effectiveness. Productive investment does not flow east: instead, labour flows West.

Meltdown avoided, but now a period of slow growth

This convergence strategy saw the build-up of significant domestic and external vulnerabilities. Most countries in the region became exposed to international capital flows, the channel through which the financial and economic crisis was transmitted to them. When the crisis struck, the worst fears of systemic economic and financial meltdown in SEE countries were avoided. The region was saved in part by the huge fiscal and monetary policy stimulus in other countries, by the rescue packages led by international institutions, and by the EU targeting the South East Europe countries for support. Nonetheless, policy and market weaknesses in the pre-crisis period now need to be addressed, and the financial liabilities built-up in the past need to be partly worked off.

All contributors in the volume seem to agree that the future growth rates will not be as impressive as they were during the pre-2008 years. The region, Sanfey underscores, will have to get used to a period of lower growth in coming years. Bastian considers that the trend growth rate of most countries in the region in the next few years will be much closer to 2-4 percent than the 5-8 percent experienced earlier. It is highly unlikely, in the view of Kaoudis et al, that South East European countries will return any time soon to pre-crisis growth rates.

In sum, the hallmark of convergence strategy in South East Europe in the run-up to the crisis was a growth pattern driven by macro convergence and financial integration, against the backdrop of structural imbalances and a weak business environment. This setting led directly to today's endemic problem in the region: the legacy of a past over-expansion of the non-traded goods sector and an over-reliance on foreign savings to sustain consumption and residential investment. When the crisis struck, macro discipline was maintained, but it was found that past budgetary policies often had left little fiscal space to buffer the economy against external shocks. There was little evidence of reforms being reversed. However, it is not clear – especially given continuing links between political and business elites in some cases – whether support can be mustered for a new wave of reforms to reflect the lessons of the crisis.

Reform Options: Towards a New Consensus?

This analysis of the pre-crisis period highlights the ways in which the pattern of growth in the region was unbalanced, allowing significant external and financial vulnerabilities to emerge. Capital inflows did not sufficiently feed into productive investment, and the competitiveness of economies was not upgraded to assure sustainable growth. Even without the capital market aftershocks of the Lehman Bros episode, a day of reckoning was to be faced at some point. And after the crisis shock, it became more obvious by the day, as Bastian puts it, that yesterday's import-led, financial sector driven and debt-fuelled transition trajectory of economic development in the region must be subject to a root and branch re-evaluation.

Schadler calls for this re-evaluation to be decisively forward-looking in nature. A critical mistake would be to focus policy adjustments on the missed or underestimated vulnerabilities of the pre-crisis period, rather than directing attention towards new vulnerabilities, or old issues that may take on new shapes. She suggests, in this connection, half-a-dozen challenges for the decade ahead as policy-makers seek to refashion the region's convergence model. How quickly and strongly, she asks, will demand in Western Europe pick up? How rapidly will financing inflows resume? Even if inflows resume, will the appetite for public debt meet the much higher supply over the next few years? Have gains in competitiveness in many countries been strong enough? Will outward labor mobility level off, resume, or even balloon after the EU derogations on open borders end in 2011?

As they consider priorities in this new and uncertain setting, the authors in this volume point to three broad areas for attention: changing the drivers of growth and its sources of financing; achieving greater risk mitigation through macroeconomic and financial policies; and exploring more effective cross-border linkages as a key dimension of a more prosperous future for the region. Cast in a broader picture, Bastian points out, the post-crisis reflection must embrace a broad reconsideration of the role of the state in South East Europe.

The need for deeper reforms

What growth model will the South East European countries decide to apply while adjusting to the necessary winding-down, scaling back exercise of relying of emergency funding from international financial institutions? This is one basic question that these papers pose. None of the authors doubts that the crisis has challenged the regional growth model, which relied on foreign financing of high levels of investment.

The answers given by the authors are broadly consistent, but they display different nuances and points of emphasis. Schadler stresses that the key tenets of the EU accession model and its inbuilt strategy of "super-integration" are not about to change. This framework for convergence in the region "will remain a fact of life." A corollary is that, over time, the use of external savings from richer EU economies will remain a core feature of the region's growth model.

Kaoudis et al do not challenge this basic intuition, but they stress that the period ahead is set to be one in which FDI will be lower than previously, and bank capital flows will decline, with both of these factors giving rise to lower GDP growth rates. Sanfey sees an implication that countries in the region will have to figure out ways to develop local sources of finance. This is consistent with the view of Kaoudis et al that, during the next few years, banks in South East Europe may need to rebalance their business, with lending growth linked to deposit growth. These adjustments, and the lower level of capital inflows as they take place, are bound to be accompanied by lower growth: "Deleveraging of the household sector dampens consumption, while corporate deleveraging reduces investment and potential GDP."

If that is the shared starting point of the authors, they also agree on the main route to rebuild more satisfactory growth levels. The road to growth in the period ahead, according to Kaoudis et al, requires that an adjustment in external imbalances be associated with deeper structural reforms in labour and product markets. Such reforms, they consider, are essential in order to increase the capacity of the economies of the region to compete with other emerging markets. Schadler is entirely at one with this view. Policies, she stresses, must be tailored toward competitiveness in the markets most likely to hold growth prospects for South East Europe countries. Now is the time to lay the base through structural reform for faster productivity growth that will ultimately keep workers at home when labor markets pick up in the West. One priority is to integrate further in supply chains feeding demand in Western Europe and generally increasing penetration of Western European markets. But whether this potential will prove adequate for nurturing rapid growth particularly of the less developed industrial structure of South East Europe will depend importantly on the strength of the recovery in Western Europe. As a safety valve, Schadler urges the need for a broadening of export bases in terms of products and markets outside the EU.

While the defining trends of the past decade were macroeconomic stabilisation, private credit growth, and income and asset price convergence, the period ahead needs to see much more attention to the structural underpinnings of growth. Wages have far outstripped productivity; and low – or suppressed – risk premia fostered a flood of unhedged borrowing that drove household leverage not too high, in some absolute sense, but overwhelmingly too fast. Remedying this in the future will require targeted regulatory reforms, which will vary across countries but with the common aim of creating a more attractive business environment across the region; and complementary reforms in the structure of the public finances and in the workings of the real economy that will help shift the pattern of growth towards one that is more labour intensive, more 'competitive' in terms of productivity growth, and less dependent on foreign savings.

The question is whether this kind of structural reform, will be resisted by the so-called "special interests" and "veto players" and remain incomplete. Some of the economies of the region have yet to extract themselves fully from the quagmire of a state that is weakened by such economic special interests. This is true of Serbia, for example, and to some degree of Bosnia-Herzegovina – both of which are cases where the reform of enterprises has yet to be completed. Yet the economies of the region can only shift their pattern of growth to a more sustainable and balanced one if they sharply address areas such as the business environment – which can help promote the traded goods sector, and inflows of FDI to that sector.

The case for more risk-averse policies

A second major theme of the papers is the need to put in place economic policies and policy frameworks that are more risk-averse. Convergence with open capital accounts has proved a riskier business than expected. Schadler asks in broad terms how the strategy of open capital account convergence has affected the strengths and weaknesses of economic performance. Do countries in the region need policy precautions that differ from those in other countries? Her answers, and those of the other authors, are strongly in the affirmative. The experience of real and nominal convergence under the *acquis communautaire* can now be seen as a riskier endeavour than many officials and private sector participants had believed. The EU accession is seen as conferring clear benefits, but, as Schadler says, "The crisis has placed in sharp relief weaknesses or risks that accompany these benefits."

One key dimension of this is that fiscal policy needs to play more of a risk-mitigating role in the future. Indeed, for several reasons, concerns about the public finances have moved to centre stage. If fiscal policy is not more credible over the medium term, this could jeopardise growth prospects and increase volatility in money and bond markets.

Indeed, fiscal consolidation may need to be achieved quite rapidly, and perhaps faster than is ideal from the point of view of supporting growth. Before the crisis, no countries in the region had established a forceful fiscal rule to help anchor policies in more difficult circumstances. In the uncertain global environment that lies ahead, fiscal adjustment would be best supported by having a public debate on a viable fiscal rule, establishing such a rule, and then sticking to it.

This argument for a risk-averse fiscal policy is heightened when it is viewed alongside a degree of uncertainty about future trends and shocks in the region. Since many macroeconomic forecasters got it wrong in the past, Bastian notes, prudence about any economic outlook for the region is appropriate. Bastian also discusses in this connection the actual and potential role of external actors such as the IMF and the EU in helping to anchor fiscal policy.

This question of risk mitigation extends beyond the realm of fiscal policy. A main focus of Schadler is the capital inflow experience, which Kaoudis et al explore financial gains and risks through the prism of cross-border banking developments. Generally, the authors see a positive balance sheet, but a lesson that more pre-emptive macro-prudential policies could have dampened the roller-coaster ride – and some lending excesses – of the past decade. The 2009 EBRD Transition Report, for all its positive conclusions, points to the risks that were associated with rapid credit growth and strong capital inflows. The weakness of economies in the crisis mapped fairly clearly to the growth of credit to the private sector during the three pre-crisis years.

Schadler derives from this a pressing need for decisions to be made on how to manage capital inflows when they resume. The horizon for this development, she admits, is fraught with uncertainty, but planning now is essential. The IMF, she notes, recently floated tentative support for various ways of putting sand in the wheels. Whether these would be permissible given EU commitments needs to be resolved now. But more than that needs to be discussed, in her view. The record on such sand-in-the-wheels policies is mixed at best—possibly they change the size and composition of inflows but probably for short periods.

A key problem facing emerging Europe, with its strategy of 'super-integration' emerges as the need for stronger and more permanent instruments to contain risks in the future. If emerging Europe is to continue to depend on large inflows from richer Western European countries, those inflows must be channelled into productive activity that does not feed bubbles in prices of non-traded goods. Now, most emerging European countries are so open that about the only truly non-traded activity is real estate and construction. Inflows into consumer credit could also be a threat to stability. If the channels for funds flowing into these activities can be narrowed directly, not through raising taxes on inflows, but rather by taxing underlying transactions (such as taking out second mortgages or having credit card balances above a prescribed limit), it should be possible to keep speculative activity below thresholds where it turns into manias and panics. It is possible to design taxes to address these problems but it takes time and careful thought. This is a task to be started decisively and soon.

When they consider the experience with capital flows and cross-border bank operations, most of the authors take monetary regimes as given. They therefore see fiscal and supervisory policies as the main bulwarks containing overall levels of risk in the economy. The question also arises whether uncertainties about these economies' exit to the euro may be confusing and increasing the riskiness of private sector decisions. The commitment to eventual currency integration appears as a potential strength. But it also has proved to be the source of harmful uncertainty, creating dilemmas for markets and policymakers – for example, encouraging residents of emerging Europe to take on foreign currency exposures.

Schadler's view on this is categorical: EU Accession-style super-integration without going the whole distance to a single currency leaves an enormous gap with attendant scope for undue risks. Large-scale use of foreign savings by emerging Europe—which given relative rates of return in any reasonably sound institutional setting is inevitable in a model of super-integration—

will entail substantial exchange rate risk until the single currency is adopted widely. Falling back on the hope that a convergence model based on super-integration can be sustained indefinitely without euro expansion is placing a great deal of faith in a low-probability outcome.

The role of cross-border linkages and regional co-operation

The pattern of growth that took root before the crisis was heavily oriented toward residential investment and consumption, so on the demand side it did not require any deepening of cross-border linkages in the region. The financing of this growth pattern, however, depended strongly on cross-border capital flows from Western Europe and on the growing integration of regional banking with banks in the euro area. Even this activity, though, was very much of a hub-and-spokes variety, without strong cross-border links between the countries of the region.

To achieve a shift in this pattern of growth towards productive investment and exports will require a deepening of cross-border linkages, and would benefit hugely from the development of a more integrated regional market. There are signs of direct investment growing across borders – for example, within the states of former Yugoslavia, but these are only emergent trends. Parallels can be drawn with the scope to achieve much stronger and more efficient networks in the region in the fields of energy and transportation, for example.

Sanfey underlines that the crisis has demonstrated clearly the benefits of cross-border co-operation, including with the private sector. He sees the "Vienna Initiative" – designed to strengthen the commitment of foreign banks – as an example that could be used as a model for other areas, one example being the development of local currency lending.

The importance of the questions posed is clear. It may not be too strong that sustainable development of the region could be envisaged as a counterpoint between integration with the EU and a deepening of cross-border links among the countries of the region. Kaoudis et al stress that the region is heterogeneous in terms of EU integration, but the overall path for a deepening relationship is shared. That co-operation in turn needs to be envisaged at several layers. The originality of the accession process is that it extends beyond the integration of goods, labour and capital, and embraces the design of institutions and policies. These too are areas in which exchanges of experience and cross-border initiatives in the region appear propitious ideas to explore.

Reconsidering the role of the state

The need to re-launch economic growth along more sustainable lines poses important challenges in terms of the political maturity of the region. There are crucial issues regarding the nature of the state, and its efficiency and public legitimacy, in most of the countries in the region. And there are pervasive issues about the depth of domestic constituencies for reform, social resilience, and finally the role that the EU can play as an external anchor for the strengthening of the states in the region.

In many ways, most of the primary concerns across the region have been political. Some pertinent questions that appear over and over again refer to whether political leaders have the courage to take difficult decision in view of potential political costs in elections? How do decades old political habits change and is pressure from abroad a sufficient way to do this? How will different constituencies react to economically difficult times and a perception that their hard-earned gains risk being erased? While it is usually a weak economy that can bring down a government, it is also hard economic decisions that can lead voters away from a governing party.

Problems with governance in South East Europe have inspired a discussion of the nature of the state, its strength and/or weakness. Indeed this was the central theme during the transition phase when the main emphasis of the West was to weaken the role of the overwhelmingly powerful communist state. A policy of privatisation and liberalisation eventually led to a reduced direct role of the state in the economy; but in many Balkan states there was a parallel and less benign weakening of the central state structures that had to do with ethnic conflicts and contested territories.

With the start of the new century and despite the good times of growth in the region, the question was not of the weak versus strong state but of the efficient versus the inefficient state - the state that could deliver public goods for its citizens. On that ground, the mood across the public in the region was quite negative even before the crisis (as highlighted in the EBRD/World Bank Life in Transition Survey), and it has certainly worsened since. There is a wide consensus that the central authorities in all Balkan countries are underperforming. This creates one of the major obstacles in the acceptance and reliability of the reform process. Publics across the region are reluctant to commit to a reform process that will bring few benefits to them and especially when the credibility of the governments pursuing these reforms is very low.

One other aspect that requires attention and will contribute to the future post-crisis period is the role of the state in providing a good business climate, economic freedom, good governance and competitiveness for domestic and foreign investments. Bastian repeatedly emphasizes the importance of re-drawing the boundaries of the state – citizens – corporate environment nexus.

The role of the state in emerging market economies such as these may need to adapt and evolve, just as it has in the advanced economies, where the private sector proved frail, and 'light touch' approaches to regulation were discredited. Across the various areas discussed above, the question must be tackled where and how the boundary between government and the market should be (re-)drawn, how the public sector can better address risk-taking in the private sector, and how the government can better create a setting for sustainable growth.

In today's political and economic setting the links of the region to the EU - and the perspective of closer integration and accession - remain more important than ever. The EU anchor is truly crucial as countries brace themselves to attempt yet a further wave of reforms in a difficult global environment. Without this EU perspective, the risks are real that some countries could slide back, with troubling implications for neighbours in the region. Yet both sides in this partnership need to reach out. The countries still aspiring to membership need to make themselves more 'attractive' - including as destinations for FDI. And the present EU members need to reach out to the region to help strengthen and underpin countries' political and economic reform efforts. Both sides, reaching out to the other, need to respond to the challenges of today's difficult setting by moving the region's EU relationship to a higher level.

Chapter 1 - South East Europe: lessons from the global economic crisis

Peter Sanfey[1]

Introduction

During the past decade, South East Europe (SEE) has undergone a dramatic transformation.[2] The extent of the progress in economic development, democratic reforms, regional cooperation, and integration into global economic and financial markets was unthinkable even 10 years ago and is unprecedented in the region's history. But the past two years have been a difficult time for all Balkan countries. The financial crisis that began to affect Western markets in the second half of 2007 took a while to be felt in SEE, but by the fourth quarter of 2008 it was clear that this region would also face a major economic slump. By the second half of 2010, there were signs that output was stabilising. Cautious optimism is being expressed that the worst is over. However, this region is lagging behind in the general recovery across the transition region and few people expect to see the high growth rates of recent years returning soon.[3]

This paper shows how the crisis has evolved in the region and why it was affected by developments that originated elsewhere. It argues that, notwithstanding the sluggish nature of the recovery, the impact has been less severe than many expected and that this resilience can be attributed in large

[1] I am grateful to Simone Zeh for her excellent research assistance, and to Marko Atanasovsky, Jens Bastian, Ivo Germann, Franziska Ohnsorge, Max Watson and Jeromin Zettelmeyer for comments and suggestions. An earlier version of this paper was published in February 2010 as EBRD Working Paper No. 113. The views presented here are those of the author and not necessarily of the EBRD.

[2] In this paper, the term "South East Europe" is generally used, rather than the "Balkans", to refer to the countries of former Yugoslavia (excluding Slovenia), Albania, Bulgaria and Romania.

[3] Forecasts produced by the EBRD on 22 October 2010 show that the average weighted growth rate in these eight countries is forecast to be negative in 2010 (-0.8 per cent), compared to an average for the whole transition region (including SEE) of 4.2 per cent. See the EBRD's latest Regional Economic Prospects, at: http://www.ebrd.com/downloads/research/economics/publications/REP_Oct2010.pdf.

part to the mature and sensible reaction of the region itself. But it also points out the vital role played by international actors. Not only has there been strong financial support from publicly owned international organisations, but also privately owned foreign companies and banks have refused to rush for the exit, reflecting a major and, so far, largely successful coordination initiative. The paper concludes that the region is well-placed to take advantage of a future global upturn – whenever that might take place – but at growth rates that are likely to be subdued compared with those seen in the few years before the crisis.

The next section describes in some detail the evolution of the main macroeconomic indicators, highlighting the relative resilience of the region and the absence of the kind of output collapses seen elsewhere in the transition region, such as in the Baltic states and Ukraine. It also explains the importance of three contributing factors to the output decline: the sharp drop in exports; the choking-off of credit; and the effect on remittances. The following section shows how the region has responded to the crisis. Most people were totally unprepared for what happened, but despite this, the reaction both of national authorities and of businesses and workers has been generally mature and appropriate to the circumstances. The next section highlights the international dimension – both the direct support from abroad and the spillover effects from the fiscal stimulus and liquidity expansion programmes in advanced countries. The final section offers some concluding thoughts and lessons for the future.

What happened, when and why?

The origins of the global economic crisis are by now well-known. They can be traced primarily to an unsustainable credit and housing boom in the United States. The problems in the United States and some other large economies, notably the United Kingdom, became evident in the second half of 2007, and the situation in the leading industrialised economies deteriorated rapidly in 2008. The United States entered recession in Q4 2007 and the UK (Q4 2008), France (Q1 2009), Germany (Q3 2008) and Japan (Q2 2008) followed behind.

By mid-2008 it was clear that the shocks to the global financial system were of a type and magnitude that had not been seen since the Great Depression of the 1930s. At this time, however, the economies of SEE continued to boom. Many people there seemed to be blissfully unaware of, or at least unaffected by, what was happening in the global economy. Banks kept on searching aggressively for market share, both on the liability and asset side. Foreign direct investment (FDI) poured into the region in record amounts, and economic growth continued unabated. Throughout the first eight months or so of 2008 there was a feeling that SEE would be able to escape the worst of the contagion from the crisis. Businesses and governments were still optimistic, after several years of strong growth combined with macroeconomic stability, increasing investment and a sense that the region was on the right path towards integration into the European Union. In fact the main macroeconomic concern in many SEE countries in mid-2008 was not that the global crisis would spill over into their countries, but rather how to tackle inflation, which had started to rise sharply, mainly because of rising oil and commodity prices.

The situation changed dramatically in September 2008. The collapse or nationalisation of several major financial institutions in the US – Lehman Brothers, AIG, Fannie May and Freddie Mac – caused such upheaval in the world economy that everyone realised there would be dire consequences around the globe, and that no country would be immune. Nevertheless, the prevailing wisdom of the time was that there would be a significant slow-down of growth in SEE in late-2008 and 2009, but that the figures would remain in positive territory in all cases.

The extent to which economists underestimated the severity of the crisis can be shown by taking two examples: the first column of Table 1 shows the forecasts for GDP growth in 2009 from the October 2008 IMF World Economic Outlook (WEO) and compares with the actual outcomes (column 3). The difference is staggering; a minimum of 3 percentage points (Albania, where 6.3 per cent growth in 2009 was projected two years ago, compared with the outcome of 3.3 per cent), and almost 12 percentage points in the case of Romania (4.8 per cent growth forecast two years ago versus an actual 7.1 per cent drop). But it would be unfair to single out IMF (International Monetary Fund) economists who were no worse than most of those from other international organisations or private institutions. Table 1 also shows (column 2) that the EBRD's forecasts for 2009 published in November 2008 in the *Transition Report 2008* differ from the outcome by a similar amount. It has been a humbling time for economists, as their inability to predict the future – long the subject of jokes – has been even more starkly exposed.

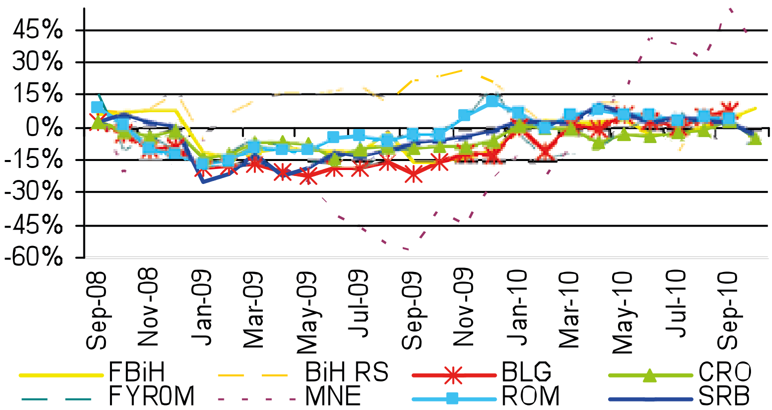
Table 1: GDP growth forecasts for 2009 - IMF World Economic Outlook/EBRD Transition Report October/November 2008 vs. actual outcome

	IMF	**EBRD**	**Outcome**
Albania	6.3	5.0	3.3
Bosnia and Herzegovina	5.0	4.5	-2.8
Bulgaria	4.2	3.8	-4.9
Croatia	3.7	2.0	-5.8
FYR Macedonia	5.0	4.7	-0.8
Montenegro	5.0	5.0	-5.7
Romania	4.8	3.0	-7.1
Serbia	6.0	3.0	-3.1

Source: IMF, EBRD

High-frequency, monthly data on industrial production give a rough idea of when the crisis really began to hit the region. Diagram 1: Industrial production percentage change y/y shows how dramatic the change was around September and October 2008. By October, all countries were showing negative year-on-year growth in industrial output except Bosnia and Herzegovina, where the picture is distorted by the re-opening of a major oil refinery in November 2008.[4] Once the figures turned negative, they stayed that way. In 2010 there are signs of bottoming-out in most countries. It should be noted that these data are notoriously volatile and do not include most economic activity in the region, which is dominated by services, but they do provide some support for the view that the region-wide recession could be coming to an end.

Diagram 1: Industrial production percentage change y/y

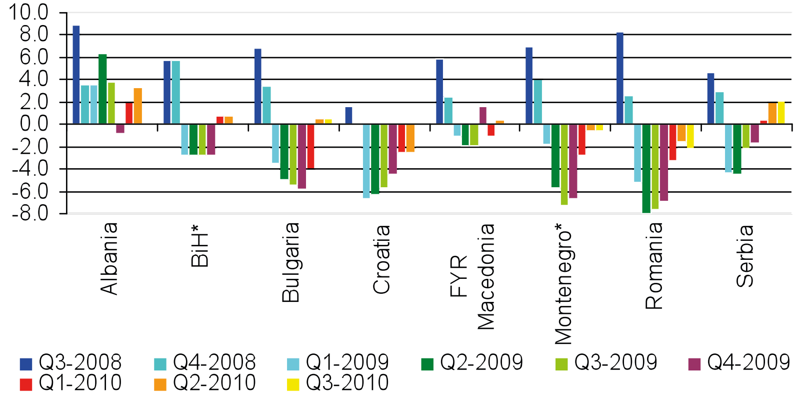


Source: National Authorities.

The extent of the downturn in 2009 can also be brought out by considering the path of quarterly output (see Diagram 2: Quarterly output y/y). Most countries still had positive growth in Q4 2008, but the full extent of the downturn was already apparent in Q1 2009 (at least for those countries that publish quarterly data).[5]

[4] Monthly data on industrial production are not available in Albania.
[5] Only "rough and ready" estimates are available for several countries, including Bosnia and Herzegovina and Montenegro.

Diagram 2: Quarterly output y/y

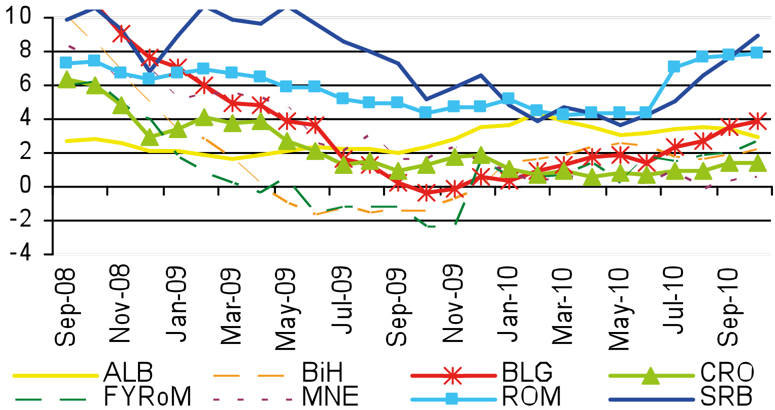


* EBRD estimates. Source: National Authorities.

The drop in economic activity has had a significant impact on other macroeconomic variables, such as inflation, government deficits, and current account deficits. It also had a serious negative effect on unemployment and poverty. It is perhaps paradoxical, however, that the crisis may have had a welcome dampening influence – in a rather brutal way admittedly – on some of the imbalances that had arisen during the boom years.

As an example, consider the course of inflation over the past two years. Diagram 3: Consumer Price Indices shows that inflation was threatening to become a serious problem again in mid-2008, with double-digit levels at that time in Bulgaria, Serbia, Bosnia and Herzegovina and Montenegro. This now seems like a distant memory. The fall in domestic demand, combined with the steep drop in the price of oil and other natural resources in the second half of 2008, has contributed in several cases to some of the lowest rates of inflation ever seen in this region. The latest rates (October 2010) even point to a deflation in Bosnia and Herzegovina. Bulgaria has moved from having the highest rate in the region in the first half of 2008 to now having one of the lowest. In the case of Romania and Serbia – two countries that have had difficulty in keeping inflation under control – lower inflation in 2009 allowed for significant cuts in policy rates (see below), although inflation has risen again in both cases in the second half of 2010, necessitating rate rises in Serbia (but not yet in Romania).

Diagram 3: Consumer Price Indices

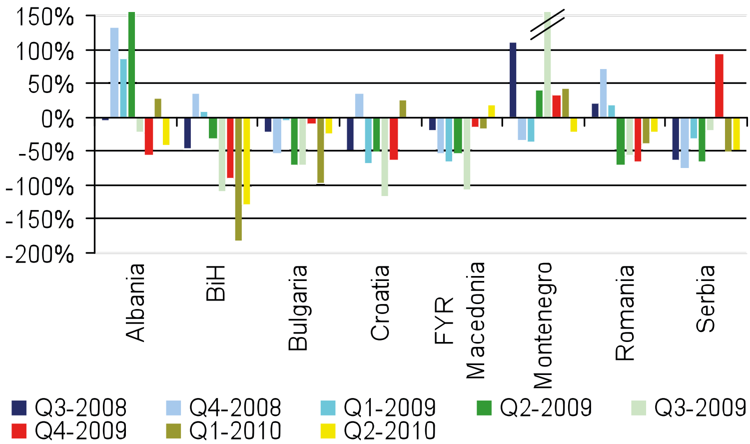


Source: National Authorities.

In a similar vein, current account deficits have come down markedly during the crisis, as a result of a steep drop in imports that has more than counterbalanced the fall in exports. As a percentage of GDP, the deficit for 2009 came down by more than 10 percentage points in Bulgaria, Montenegro and Serbia, and by significant amounts in Bosnia and Herzegovina, FYR Macedonia and Romania. It would be misleading, as many commentators do, to refer to a fall in the current account deficit as an "improvement"; the fact that the recession has meant that firms and people are unable to afford imports to the same extent as before is hardly a cause for celebration. However, to the extent that the previous high deficits were unsustainable, it does represent a move towards a growth model that is less heavily dependent on capital inflows.

Even at lower levels, however, current account deficits have to be financed on the capital side; otherwise the effect will be seen through a loss in foreign reserves. The region has relied on, and benefited greatly from, FDI which has entered in increasing amounts, culminating in a record US$ 33.4 billion in 2008. But the year 2009 saw a steep drop (more than 30 per cent on average) across the region. Even in 2010, no clear upward trend can be recorded (see Diagram 4: Net FDI percentage change y/y). The extent of the falls varies by country; Albania and Montenegro actually saw a rise in 2009 thanks to some important privatisation deals (an oil refinery in Albania and the power sector in Montenegro), but these were outliers.

Diagram 4: Net FDI percentage change y/y



Source: National Authorities via CEIC data service.

Channels of contagion

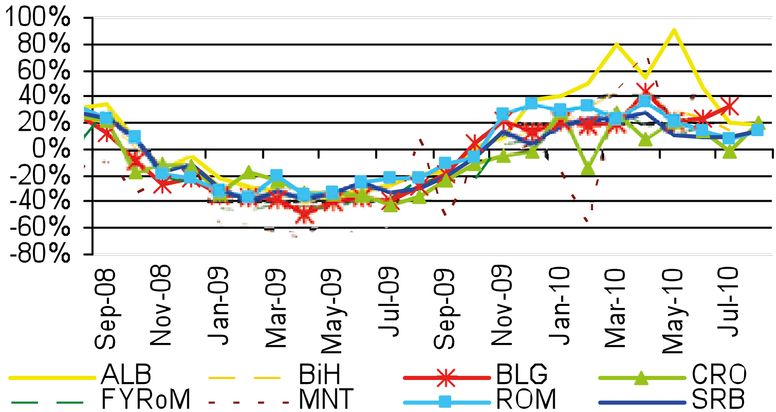
The past two years have brought out clearly the extent to which SEE is now part of the global economy. While this integration process has brought enormous benefits to the region in the past decade, the downside is that crises that originate elsewhere will affect the region, no matter what actions are taken to mitigate these effects. In the case of SEE, the fall in output has numerous causes. Three explanations stand out as particularly important. First, external demand from the main export markets dropped sharply, especially for some key commodities that are now produced in the region. Second, access to finance became much more difficult or expensive, which is a serious impediment to the operation of businesses in the region. And third, the volume of remittances has fallen, which in turn is depressing domestic demand as well as hindering the development of small businesses. Each of these will be considered in turn.

Monthly exports are volatile series in SEE, as Diagram 5: Exports fob Percentage change y/y shows.[6] In the first half of 2008, most countries had exports growing at around 30-40 per cent year-on-year. After September 2008, demand from abroad dried up and exports collapsed, to a level where year-on-year growth was close to, or even worse than, *minus* 40 per cent by early 2009. By the end of the year, however, export growth had returned to positive territory with the exception of Croatia (though this may be a base effect, given exceptionally rapid growth a year earlier). This recovery in exports

[6] Monthly data on exports from Montenegro are not available.

has continued throughout 2010 and constitutes one of the main reasons for optimism about medium-term prospects.

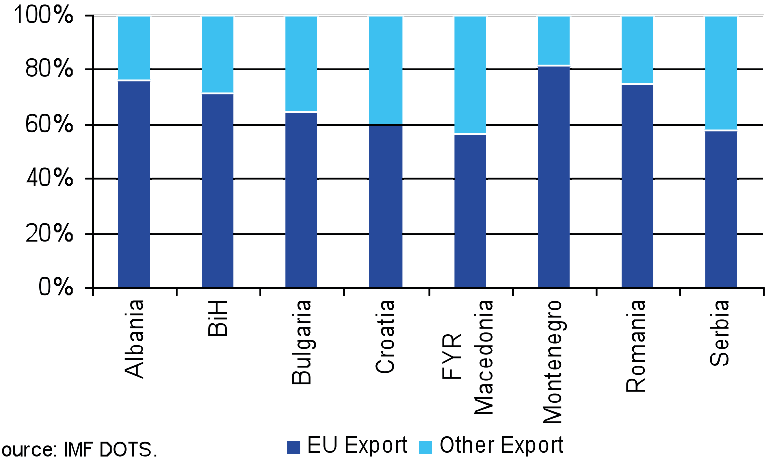
Diagram 5: Exports fob Percentage change y/y



Source: National Authorities via CEIC Data service.

In order to get a better understanding of why exports dropped during the height of the crisis, it is important to know *what* countries are exporting, and *where* the exports are going to. In recent years, many countries of the region have developed a specialisation in certain key industries. The steel sector is particularly important in Bosnia and Herzegovina, FYR Macedonia, Romania and Serbia. Aluminium is the main export earner in Bosnia and Herzegovina and Montenegro. Romania also has a strong car industry through the Dacia plant (now owned by Renault). Tourism is an important part of the Bulgarian, Croatian and Montenegrin economies. All of these industries were particularly hit by the global recession, and this is a major factor behind the decline in output in the region. Exposure to the EU-27 has offered little protection; exports have tended to perform badly whether or not a country exports mainly to the European Union (such as Montenegro, where 81 per cent of exports are EU-bound) or Serbia, where just 58 per cent of exports go to EU countries (see Diagram 6: Share of exports to the European Union in 2009).

Diagram 6: Share of exports to the European Union in 2009

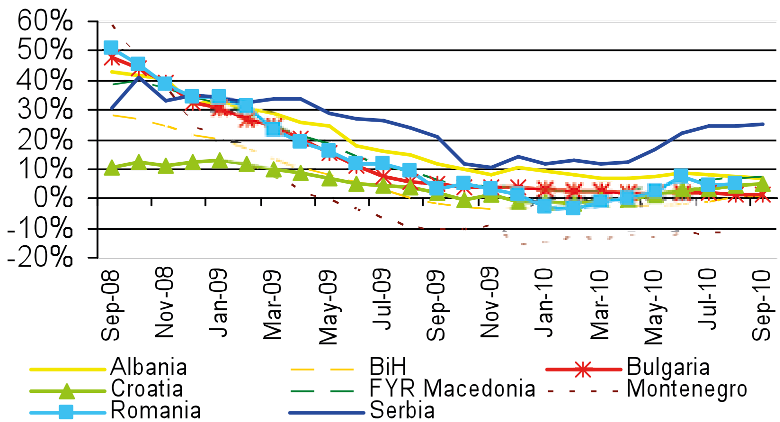


Source: IMF DOTS.

Banks and other financial institutions have been major drivers of economic growth in the past decade, but also of rising vulnerabilities. In the pre-crisis period, virtually all countries in the region had four or more years in a row of a credit boom, defined as annual growth in total credit to the economy by more than two percentage points of GDP (for evidence on this, see the EBRD *Transition Report 2009*, Chapter 3). The most extreme example is Montenegro, where credit growth at one point was close to 200 per cent (year-on-year). The effects of this growth could be seen in various ways. Many small and medium-sized businesses thrived as they accessed loans at reasonable rates, perhaps for the first time in their existence. Households increasingly enjoyed the new capability of buying (mostly imported) consumer items, as well as taking on mortgages to purchase property. A property boom became noticeable in some of the main cities of the region – Bucharest, Belgrade and Sofia – as well as in tourist-oriented coastal areas in Bulgaria, Croatia and Montenegro.

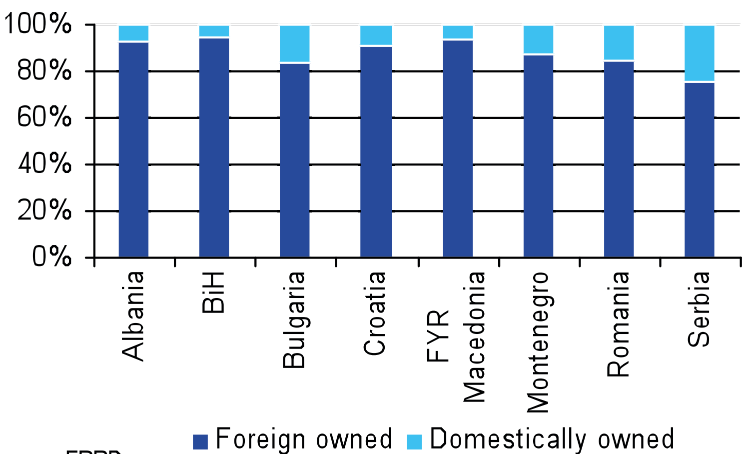
The crisis has contributed to a dramatic slow-down in this growth. In most countries, year-on-year credit growth was still positive until early 2010 but in low single-digit levels (see Diagram 7: Private sector credit growth percentage change y/y). Conversely, credit growth in Bosnia and Herzegovina, Croatia and Montenegro had already turned negative towards the end of the year. But the situation could have been worse. The most important reason why credit was not shut off completely must lie in the fact that foreign banks dominate in the region and, as recent research has shown, a high presence of foreign banks has helped to mitigate capital outflows (see the EBRD's *Transition Report 2009*). Diagram 8 : Share of foreign banks in 20098 shows the percentage share of foreign bank capital in the total in each country. The figures range from 75 per cent in Serbia to 95 per cent in Bosnia and Herzegovina. In other words, foreign banks largely control banking sectors in the region, with all the attendant benefits and risks that this dominance entails. Keeping the banks on board in the crisis has been one of the region's biggest concerns, and is a topic examined below.

Diagram 7: Private sector credit growth percentage change y/y



Source: CEIC data

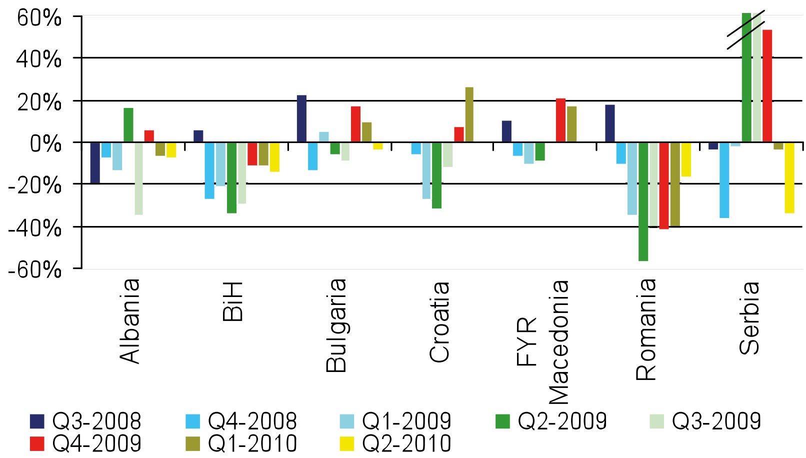
Diagram 8 : Share of foreign banks in 2009



Source: EBRD.

Lastly, the crisis has affected remittances, which have proved a vital source of foreign exchange inflows over the years for most of the region, and indeed a lifeline for many families and small businesses. Diagram 9: Remittances percentage change y/y below reports the latest year-on-year percentage change (Q3 2008 until Q2 2010) in remittances, based on data from the CEIC database. Several countries show a significant decline, in particular in Romania, Bosnia and Herzegovina and Croatia. However, the data also indicate that remittances seem to have increased significantly in Serbia throughout 2009, due to an unexpectedly large inflow in the second quarter

Diagram 9: Remittances percentage change y/y



Source: National Authorities and IMF via CEIC data service.

How did the region react?

The macroeconomic figures show how bad the situation has become, but it is important to mention some things that could have happened, and might even (based on the experience of previous crises) have been expected to happen, but did not. First, there has been no failure of a major bank, and no uncontrolled devaluation of pegged (or near-pegged) currencies. Second, there has been no breakdown of social order and no dramatic rise in unemployment, although the latter is rising throughout the region and may continue to do so even as economies return to growth. And third, there has been no major backtracking in reform. This section and the following one examine some of the reasons for these small but important crumbs of comfort.

Once the full extent of the crisis became clear in the region, a sense of urgency and even panic set in among policy-makers, businesses and ordinary individuals. There was enormous pressure on governments to be seen to be "doing something" and to come up with some kind of "crisis response" package. But while the intentions were usually good, the means to carry them through were weak or non-existent. For central banks, the crisis entailed a major reversal in thinking. Having become accustomed to worrying and warning about excessive credit growth and its inflationary impact, suddenly they had to deal with a possibly precipitous drop in credit, perhaps combined with a loss of confidence in the banking system. Meanwhile businesses wondered what to do about falling demand – should they cut back production and lay off workers immediately, or would it be better to retain people and hope that things would improve in the near future? And for the population at large, the crisis came at a time when people were already less than happy with their lot. The economic downturn could have been an excuse for further discontent and even social protest.

Governments

Governments throughout the region faced an immediate dilemma: spend less to offset shrinking tax revenues and risk cutting domestic demand even further, or spend more and risk crowding out private investment and possible credit rating downgrades. Traditional Keynesian theory, which has come back into fashion in the United States, United Kingdom and other large Western economies, suggests that governments should spend more in a recession to counteract the fall in private demand. But, unlike in the United States and other large Western countries, governments in SEE had no obvious means to finance such a deficit-spending programme. The cost of borrowing either on domestic or international markets, on the scale that would be necessary to have a real effect, would be prohibitive in most cases. During 2009, only Croatia in this region tapped international capital markets to any great extent, doing so in May and October 2009 and raising a total of nearly €2 billion. For others, this was not an option at the time. In 2010, the crisis in Greece led to postponements of Eurobond issues by Albania, FYR Macedonia and Montenegro, although both Albania and Montenegro have since placed bonds successfully.

Most governments introduced various fiscal programmes that appeared to be expansionary but in reality had little impact on the actual economy. In Romania, the government announced in February 2009 a €13 billion stimulus package to help counteract the worst effects of the crisis. The idea was to earmark most of it (more than €10 billion) for infrastructure projects. However, few projects have got off the ground so far and the effect on economic growth has been negligible. Other countries have tried tax breaks to stimulate businesses. Serbia launched a package in February 2009 which included investment loans at subsidised rates to businesses, as well as consumer loans for the purchase of Serbian goods. In a similar vein, the FYR Macedonian and Montenegrin governments tried to reduce the tax burden by selective cuts for businesses and households, while in Bosnia and Herzegovina, a targeted programme for the less well-off involved the exemption of certain essential goods from VAT. All of these measures have brought some relief here and there, but they cannot be said to constitute a coherent anti-crisis approach.

The room for manoeuvre was further limited by the fact that most governments had run fairly expansionary fiscal policies during the boom years, and therefore had little in reserve when the downturn arrived. Collapsing revenues and limited access to new borrowing therefore forced most governments to reduce spending. This is not easy to do, and most were rather hesitant. In Croatia, where government spending (as a percentage of GDP) is among the highest in the region, the government played a kind of catch-up game in 2009, revising the budget three times, with each revision accompanied by further spending cuts and a downward revision of the GDP growth forecast. Those countries that have IMF programmes – Bosnia and Herzegovina, Romania and Serbia – have found the Fund surprisingly lenient (compared with its traditional approach) in accepting relatively substantial government deficits, and (in the case of Romania and Serbia) in agreeing to upward revisions of the deficit target both in 2009, and again in 2010, once the full extent of the economic downturn became clear. But big fiscal challenges remain. Continued IMF support will depend on serious efforts to place public spending on a sustainable, lower path. In countries that have frequent elections and potentially unstable coalition governments, this will not be easy.

One of the most important steps taken by many governments in the region has been to increase the level of deposit insurance and shore up confidence in the banking system. In the last quarter of 2008, the need for this became absolutely urgent. Several countries were facing a serious loss of confidence in their banking systems, especially Bosnia and Herzegovina and Serbia. In both cases, people have relatively fresh memories of hyper-inflation and of effective confiscation of foreign deposits. It is estimated that there was a foreign currency deposit outflow of €1 billion (15 per cent of the October level of deposits) in Q4 2008 in Serbia and around €400 million in Bosnia and Herzegovina. There were also fears about significant outflows in Croatia and Montenegro. In each case, decisive action was taken – Croatia and Serbia raised the limit to approximately €50,000 in October 2008, while in Bosnia and Herzegovina, the limit was raised more modestly to around €10,000 in October 2008 and around €18,000 in April 2010.[7] The Bulgarian parliament approved an increase to €100,000 in November 2010. Montenegro went

[7] An EBRD loan to the deposit insurance agency in Bosnia and Herzegovina, signed in January 2010, should enable the level of coverage to be raised to around €25,000.

furthest of all, by issuing a 100 per cent guarantee on all deposits, again in October 2008.

Initially there was scepticism and even cynicism about the credibility of such deposit insurance. Indeed, no government would have been able to fully recompense depositors in the event of a serious bank run and subsequent collapse of major banks. But this criticism misses the point that these steps did help engender a new sense of confidence among the population at large, as witnessed by the steady return of deposits since the dark days of Q4 2008. In both Bosnia and Herzegovina and Serbia, the level of deposits had, by the end of 2009, returned to where it was before panic set in, vindicating the actions both of the government and of the central bank.

To sum up, governments were right to signal support to their financial systems in late 2008, but had insufficient fiscal means to arrest the crisis and make things easier for firms and households. More encouraging is the fact that they have, almost without exception, avoided the temptation to roll back the structural reforms that have been put in place over the previous two decades. There has been a significant slow-down in reforms as governments have generally been too distracted with crisis management. Some important potential privatisations – shipbuilding in Croatia, telecommunications in Bosnia and Herzegovina, mining in Serbia – have failed or been delayed, mainly because it is hard or even impossible to find investors in the present climate. At the same time, there seems to be no appetite at all for a major reversal of the reform programme of the past two decades.

Central banks

In general, central banks throughout the region have reacted sensibly and effectively to the crisis, albeit in different ways. This reflects the fact that, over the past decade, all central banks in the region have built up a reputation for independence, competence and professionalism, qualities that are often lacking in other public sector institutions. Of course they cannot be exempt from criticism in the boom years. In retrospect, some of them would have been well-advised to follow the example of the Croatian central bank in imposing strict upper limits on credit expansion (although even in Croatia this came somewhat late in the credit boom period). Others were arguably too relaxed about the extent of lending in foreign currencies, particularly in "exotic" currencies like the Swiss franc or the Japanese yen, where seemingly attractive low rates of interest may have concealed the high risks (through depreciation of the local currency) facing the borrower. But once the crisis entered into full swing, the central banks generally played an important calming and mitigating role.

The tools available to central banks in SEE are limited. Most can set a key policy rate (usually some kind of short-term repo rate), which in turn affects interest rates elsewhere in the economy; they can vary the reserve requirement rate (with differential rates depending on the denomination and maturity of the deposit); and they can use foreign reserves to intervene on the foreign exchange market to defend the currency. Central banks have used a combination of these policies at some stage in the past two years.

The biggest reduction in the policy rate has been in Serbia, where the two-week repo rate was lowered by a cumulative 975 basis points since January 2009, to a rate of 8 per cent as of May 2010; this trend has been reversed since August (four rate increases to 10.5 per cent as of early December 2010) in light of increasing inflation. Inflationary pressures tend to be higher in Serbia than in other countries of the region, and memories of high or even hyper-inflation are still strong. Therefore, the central bank had aggressively raised interest rates during the boom times in an effort to keep a lid on inflation and credit growth. The recession allowed this policy to be reversed, while still keeping inflation on a downward path, until mainly external pressures on prices forced a reversal in the second half of 2010. A similar pattern emerged in Romania, although the extent of the reduction was smaller: 400 basis points (down to 6.25 per cent as of early-December 2010) since the start of 2009. Significant policy rate cuts have also occurred in Albania and Bulgaria.

In Croatia and FYR Macedonia, in contrast, the central banks were initially reluctant to cut policy rates as a crisis response, reflecting a different approach to exchange rate policy. In fact, the move was initially in the other direction: The Croatia central bank raised the key policy rate from 4.5 per cent to 9.0 per cent in November 2008 as part of its efforts to defend the tightly managed float policy. In FYR Macedonia, which has an even harder peg, the policy rate (i.e. the rate on central bank bills) was raised in March 2009 from 7 to 9 per cent (but subsequently cut since then, ending at 4 per cent in December 2010). This tool is not available in Bosnia and Herzegovina, which has a strict currency board, or in Montenegro which has unilaterally adopted the euro.

When it comes to reserve requirements, there has been far more uniformity in response. Most countries have lowered the mandatory reserve requirement at some point in the past two years, in an effort to ease liquidity and encourage banks to keep lending, or at least to cut lending by less. There is still wide heterogeneity in the region in reserve requirements. In Bulgaria for example, minimum reserve requirements on funds attracted by banks from abroad were reduced from 10 to 5 per cent in January 2009, while those on government deposits were eliminated. In neighbouring Romania, in contrast, reserve requirements on foreign currency-denominated liabilities have come down progressively from an initial rate of 40 per cent to 25 per cent (those on local currency liabilities are 15 per cent). The overall direction though is clear: central banks during the crisis have been primarily concerned about getting lending to the real economy, and they recognise that excessive reserve requirements can hinder this process.

As already mentioned, there have been large differences in exchange rate policy within the region. They range from managed floats (Albania, Romania and Serbia, with Croatia also having a tightly managed float); Romania and Serbia saw significant depreciation of their currencies in 2008 and early 2009, and again in Serbia during 2010). Other regimes include a peg in the case of FYR Macedonia, currency boards in Bosnia and Herzegovina and Bulgaria, and unilateral euroisation in the case of Montenegro. But despite the differences, one common thread has run through exchange rate policies since the early 1990s. All countries recognise the value of exchange rate stability and are prepared in most circumstances to intervene in the foreign exchange market to prevent excessive fluctuations (the obvious exception being Montenegro where there is no local currency to defend). Even in the two countries that allowed large depreciations (Romania and Serbia), there was significant central bank intervention to prevent an even bigger drop.

Firms and workers

At the firm level, the response to the crisis has been broadly as expected. Many enterprises have had to cut back on production and lay off workers. Others have resorted to wage cuts or freezes in an effort to contain costs. The big metals producers in the region – US Steel in Serbia, ArcelorMittal in Bosnia and Herzegovina, FYR Macedonia and Romania, KAP in Montenegro and Silmak ferro-alloy furnace in FYR Macedonia for example – all had to cut production drastically for a period, and some firms resorted to introducing a reduced working week, as a way of retaining staff and minimising job losses, presumably in the hope of a global upturn.

The reaction of ordinary individuals and workers has been perhaps one of the most surprising and encouraging features of the crisis. At the start of the crisis, there were fears that an economic downturn would trigger severe social unrest. These fears were fuelled by the fact that people in this region seem to be quite discontented with life even in the boom period. The EBRD/World Bank Life in Transition Survey (LiTS), carried out in 2006, showed a marked difference in average life satisfaction between SEE countries and other transition regions, with SEE countries typically near the bottom of the entire transition region. The Gallup 2009 Balkan Monitor provides further support for this rather bleak view of the region's inhabitants (at least those in the Western Balkans) as incorrigible pessimists. But so far this has had little effect on the political life of these countries.

It is true that there have been some significant protests, but what is perhaps surprising is the scarcity of these events. One of the biggest worker protests so far was in Romania, which had a major one-day strike in October 2009, when around 800,000 public sector employees protested about government measures to freeze wages and reduce pensions. Further large protests occurred in May and October 2010. Other significant protests occurred in Bulgaria in January 2009, involving street rallies; in Serbia in April 2009 when several thousand members of the Sloga independent unions protested in Belgrade against the government's crisis response (or the inadequacy thereof); and more recently in Bosnia and Herzegovina. Since then, unions in Serbia, Croatia and Romania have threatened further strikes, but these have generally not come to pass.

Why has this been the case? One hypothesis is that people have understood that the recession in their country is driven primarily by global forces, the likes of which the world has not seen since the 1930s. That means that they are less likely to blame their misfortune on the incompetence of local politicians. Indeed, where elections have been held, incumbent governments have often done quite well, notably in 2009 in Albania and Montenegro where they were successful in gaining re-election. Similarly, the ruling party in the March 2009 presidential elections in FYR Macedonia was also successful, reflecting the popularity of the dominant party in government. In Romania, the coalition government collapsed in October 2009 as a result of internal divisions, but the eventual outcome has been the return of substantially the same government (and the same Prime Minister), although a major reshuffle occurred in September 2010. In Bulgaria, the government was thrown out by the electorate in the parliamentary elections in July 2009, resulting in a new government that is, if anything, even more committed to macroeconomic stabilisation and reforms.

The role of the international community

Countries in SEE have needed help from abroad in coping with this crisis. Over the past decade, the region has greatly benefited from, and relied on, a combination of official support – from bilaterals and from international financial institutions (IFIs) – and support from private investors and banks. Once the crisis began to take root, there was a palpable fear that the region might be abandoned to its short-term fate. But the reverse has happened; the international community, and IFIs in particular, have stepped up their support for the region in a major away. Perhaps more surprisingly, under the "Vienna Initiative" – a public-private coordination forum involving all major financial stakeholders (see EBRD *Transition Report 2009*, Box 1.4 and following) – foreign banks have also pledged support to their subsidiaries, and have backed this up in several cases (specifically, those countries that have IMF programmes – Bosnia and Herzegovina, Romania and Serbia in SEE, as well as several other countries in other parts of the transition region) by publicly committing to maintaining the level of exposures at end-2008 levels. This may be the most important reason for the absence of either a currency collapse or a failure of a major bank in the region so far.[8]

Among the IFIs, the most dramatic shift in both direction and speed has occurred in the IMF. For several years, this institution had been winding down its financial operations in SEE. Countries in the region increasingly felt that they no longer needed balance-of-payments support from the IMF, although technical support in selected areas would still be welcome. Moving away from Fund-supported programmes became almost a rite of passage for countries on their way to greater prosperity and EU integration. For its part, the IMF had little choice but to accept this situation. By September 2008, the only country in the region with an IMF-supported programme was Albania, and throughout 2008, IMF offices were closed in several countries, including Bosnia and Herzegovina and Serbia. The IMF office in Bucharest (which covers both Romania and Bulgaria) was also scheduled for closure in early-2009, but this plan was reversed when it became clear that the Romanian authorities were likely to seek a programme.

Since the start of 2009, an extraordinary turnaround has occurred. The first country in SEE to approach the IMF for a programme was Serbia, which secured a precautionary arrangement in January 2009. Very soon, it became clear to both sides that the country would need more than this, and so this arrangement was replaced in May 2009 by a 27-month extended arrangement of around €3 billion. The value of this programme to the Serbian authorities is two-fold. First, it provides assurance to foreign investors that the country has adequate foreign reserves to meet its obligations. That is the usual rationale for IMF loans. But perhaps equally importantly in the Serbian context, it gives the authorities some political cover for taking difficult decisions in sensitive areas such as public sector employment reductions or pension reform. Given the unwieldy multi-party structure of the current government, with many competing and potentially incompatible interests, IMF backing is vital. The programme encountered a minor delay in the second review in autumn 2009 but as of late-2010 it remains on track.

The Serbian agreement was followed in 2009 by new programmes with Romania (in March) and Bosnia and Herzegovina (in July). The Romanian deal was particularly substantial, reflecting the gravity of the economic situation and the needs of the country. The total value was just under €13 billion, spread over more than two years, and this was tied explicitly to a further €5 billion of support from the European Union. At the same time, the EBRD and World Bank pledged that they would aim to invest around €1 billion each over 2009 and 2010. The result was therefore a headline package of IFI support of €20 billion, enough to reassure most investors, and the

[8] The role of "external anchors" in mitigating the effects of the crisis is analysed more fully in Chapter 4 of this volume by Jens Bastian.

effect in terms of improving confidence and lowering risk perceptions was immediate. The situation was complicated temporarily by the collapse of the government coalition in October 2009 and the initial failure of parliament to approve a budget for 2010, but the formation of a new government unlocked the problem and enabled the programme to remain on track. Meanwhile, the programme in Bosnia and Herzegovina, which amounts to €1.2 billion, also remains broadly on track; an IMF programme review in November 2010 positively acknowledged Bosnia and Herzegovina's performance under the arrangement, but agreement on disbursing the next tranche, expected for end-December, depends on the finalisation of the negotiations on the general government budget for 2011.

Will other countries in the region go the same way and adopt an IMF programme? So far, there is a reluctance to adopt this path. Memories are still raw in some cases from the difficulties encountered during previous programmes and the perceived intrusiveness of the IMF in decision-making. But the IMF has learned some lessons from the past too. The new programmes in the region, and those in countries such as Hungary and Latvia, are generally less prescriptive and contain fewer conditionalities than previous programmes did. There is also more flexibility in allowing parts of the funding to be used for budgetary, rather than balance of payments, support. While it would be unfair to characterise the new-look IMF as handing out the money with no questions asked, the strings attached to disbursement are much more narrowly defined than before.

Other institutions active in the region – the EBRD, EIB and the World Bank – have also stepped up their support. All three institutions joined forces in February 2009 to declare strong support for the banking sector across the whole transition region, including South East Europe. The headline figure was €24.5 billion in new funding for banks over the next two years – arguably small in comparison to the potential needs of the sector but an important step nonetheless. But the support is not just confined to the financial sector. All three institutions are active in infrastructure – helping to build and refurbish roads, railways and power systems – and in the corporate sector to ensure that financing for businesses is still available on reasonable terms.

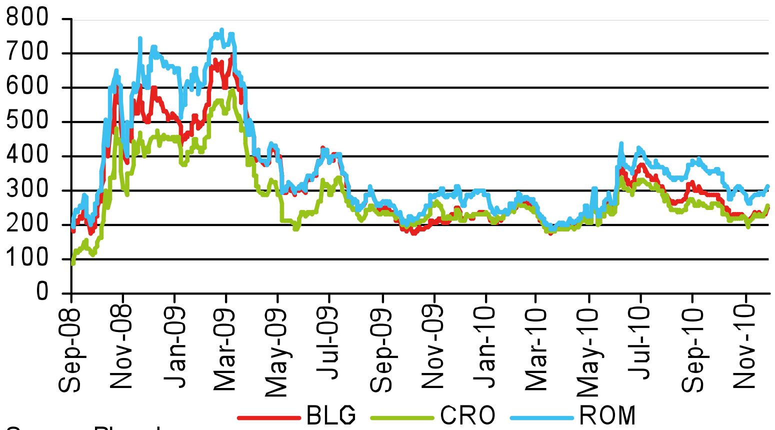
The European Union has also shown some unusual flexibility in helping non-member countries with fiscal support and with broader support for banks and SMEs. In July 2009 the European Union pledged €100 million in budgetary support for Serbia (two tranches of €50 billion, one in autumn 2009 and the other in spring 2010), under the Instrument of Pre-Accession (IPA) programme. This is the first time the IPA has been used for direct assistance to the budget. And in August 2009, the European Union gave €39 million to Bosnia and Herzegovina in support of SMEs, infrastructure, environment and energy, as well as enhanced funding for the deposit insurance agency.

This shows that the soft power of the European Union can also be backed up with hard cash when necessary, something that may surprise those who see the European Commission (the executive arm of the European Union) as excessively bureaucratic.

IFI support is not just about pumping in money; it also involves coordination, information-sharing and even a bit of arm-twisting now and again. The crisis has resulted in an innovative initiative whereby international institutions such as the EC, EBRD and IMF have helped to ensure that foreign-owned banks in the region will continue to receive support from their parent banks in Western Europe. The key idea of the "Vienna Initiative", as it is commonly known, is to ensure voluntary buy-in from these banks, in the context of IMF-supported lending programmes to the country. In some cases, financial institutions receive IFI funds directly as an incentive to on-lend to the enterprise sector. In March 2009, the main foreign banks active in Romania and Serbia committed publicly to maintaining their support for their subsidiaries throughout 2009, recognising that it was very much in their own best interests. A similar pledge was made by the six main foreign-owned banks in Bosnia and Herzegovina in July 2009. Without IFI support, it is unlikely that these banks would have been able to come to such an agreement, and the likelihood of one or more banks jumping ship would have been much higher.

The overall effect of international support can in principle be quantified by computing the amounts pledged and disbursed, but such a calculation would miss an important part of the story, namely, the return of some level of confidence to the region. One way to see this is to look at how credit default swap (CDS) spreads have evolved during the crisis. Data are available for the three larger economies: Bulgaria, Croatia, Romania, and are shown in Diagram. The peak in most cases came around February or March 2009, when the sense of panic about the region's prospects was at its height. Since then, the path has been steadily downward, to the point where spreads are not that far above their pre-crisis levels. We can expect to see some volatility in the coming months, and maybe upward blips in light of the renewed Eurozone debt crisis, but nothing like as bad as it could have been. A contributing factor to this was the international community's response package.

Diagram 10: CDS spreads



Source: Bloomberg.

The outlook and lessons learned

As of early-December 2010, the region is in a state of calm, economically speaking. Of course, that is not how those who are going through the crisis might see it. The effects have been devastating for many people, especially those who have lost their jobs or faced cuts to wages or benefits. There is also the fear that we have not seen the worst yet, that unemployment will get much worse, and that banks have hidden or ignored deep balance sheet problems that will inevitably emerge at some point. But notwithstanding these points, it does seem to be the case that most economies have reached some kind of turning point, and that a return to growth, albeit at rather anaemic levels, can be contemplated with some confidence.

The outlook for 2011 is not particularly bright, but one small note of encouragement is that all countries should see positive economic growth. The EBRD's latest forecasts (issued on October 22, 2010) foresee growth rates of between 2 and 3 per cent for all countries except Croatia (just below 2 per cent) and Romania (almost 1 per cent). These two economies have been particularly hit by the crisis and the carry-over effect of two years of negative growth implies a period of subdued growth at best. The highest growth in 2011 may be in Serbia, where a number of large infrastructure projects are under way, helping to fill the gap left by weak private sector demand (are shown in Diagram 10).

It should be noted that even the short-term outlook is clouded by considerable uncertainty. The region's recovery prospects depend to a large extent on developments in the main export market – the eurozone. Although growth has improved in recent months, notably in the biggest economy (Germany), the strength of this recovery is rather uncertain. At the time of writing (early December 2010), markets are convulsed by doubts about the sustainability of the euro project itself and of the debt-servicing capacity of some peripheral eurozone members. The recent bail-out of Ireland through a combination of support from the IMF, EU and ECB is expected to be followed by similar packages for other countries. These developments have the potential to greatly reduce confidence in the recovery prospects of the eurozone, with negative knock-on effects in SEE.

What are the main lessons learned from the crisis? It is tempting to say that it is too early to say; that we have to wait and see if there are major second-round effects and, if so, how the region will cope with these. However, it is possible to come to preliminary conclusions about what the crisis has taught us. Five points come to mind.

First, market-oriented reforms have become deeply embedded in the region. It is notable that there has been little or no reversal of previous reforms during the crisis. Almost no-one has suggested that it would be a good idea to re-introduce price or exchange controls, or to renationalise major companies and banks. There have been a few isolated cases of the state stepping back in to alleviate a difficult situation. An important example is the partial re-acquisition by the Montenegrin state of KAP. But this action must be seen in context; KAP is enormously important to the Montenegrin economy and a sudden closure of the company would have devastating knock-on effects. The government's response may therefore be seen as the most appropriate one under the circumstances.

Second, the region will have to get used to a period of lower growth in coming years. It is now clear that the previous model, relying on massive capital inflows to fuel double-digit current account deficits (see Chapter 3 for data), will not return in the short run, and probably not even in the medium or long term. Banks are bound to be much more cautious in the future, especially when it comes to cross-border lending, and they are also likely to face a tougher international regulatory regime. This means that SEE countries will have to figure out ways to develop local sources of finance and, while there are ways in which this can be achieved, it is likely to take a considerable length of time.

Third, more emphasis is needed on putting mechanisms in place for credible, multi-year planning of fiscal policy. Although fiscal deficits were in most countries quite modest during the boom years, it is now obvious in retrospect that they should have been more conservative. In some countries – Romania being a prime example – implicit long-term commitments were made on public wages, pensions and other benefits that might have been feasible if growth rates of 6-7 per cent continued indefinitely, but are definitely not sustainable in a lower growth scenario. But unwinding these commitments is politically very costly. Ultimately, the introduction of far-sighted fiscal policy requires far-sighted policy-makers and voters. In this respect, recent progress in establishing fiscal councils and/or introducing fiscal responsibility legislation in several countries of the region (examples include Bosnia and Herzegovina, Croatia, Romania and Serbia) is an encouraging signal of a stronger commitment to future fiscal discipline.

Fourth, the crisis has demonstrated clearly the benefits of cross-border cooperation, not just among government officials and international organisations but also with the private sector. Cooperation is not just about one side giving the other money, but also about information-sharing and demonstration effects of best practice, leading to more probing and courageous financial stability analysis. Before the crisis, central bank governors in the region sometimes complained that they had to rely on foreign newspapers and other media to find out what parent banks were up to. The "Vienna Initiative" could also be used as a model for other areas, one example being the development of local currency lending, where a more coordinated approach to regulation could help to unlock sources of local currency funding and, through that, promote safer lending to the corporate and household sectors.

Fifth, this paper pointed out how the crisis has demonstrated the inadequacies of the economics profession when it comes to predicting the future. In defence, one can say that this crisis was a once-in-a-lifetime global event, the effects of which were impossible to predict. It is hoped that an understanding of the channels through which events in one part of the world were transmitted elsewhere will help economists build more accurate and meaningful models. Policy-makers need to make judgements about the future when deciding current policy. If the crisis leads to future forecasts that are less wildly inaccurate than those in the recent past, it will be a small but important step forward.

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Chapter 2 - Rethinking the South East European convergence model

Susan Schadler

Introduction

South Eastern Europe was hit hard by the 2008-09 global slowdown.[9] This setback came after several years in which the region had experienced one of the fastest growth periods in recent memory. It seemed that many of the countries had started down the path of their northern neighbours—countries that had earlier stabilized their economies, started post-central planning reforms, and cemented bonds with the EU—and might well also ramp up the pace of their convergence to Western European income levels. The harsh effects of the crisis in Western Europe, however, spilled over to South Eastern Europe (SSE) rapidly after September 2008. While South East Europe on average was not hit as hard as the average of Central Europe and the Baltics (CEB), SEE countries suffered more pronounced recessions on average than other groupings of emerging market countries.

Analysis of what caused the severe output losses has already started to appear.[10] To a large degree, consensus is emerging on the view that the severity of the crisis in SEE was more a function of its close ties to Western Europe, where the output and financial market setbacks were large even by advanced country standards, than of domestic factors. And, though we hope and expect that the particular nature of the global 2008-09 crisis was unique, it is still essential to understand the transmission channels for the impact of the global disruption on the economies of SEE. Beyond that, it is also important to

[9] Throughout this paper I take South East Europe to comprise nine countries: Albania, Bosnia, Bulgaria, Croatia, Macedonia, Montenegro, Romania, Serbia, and Turkey. Many of the figures, however, include a subset of these countries due to limited availability of data. Please also consult Chapter 1 of this volume by Peter Sanfey.

[10] See (Sanfey, 2010), EBRD (2009), Bakker and Gulde (2010) and Gligorov et al (2010).

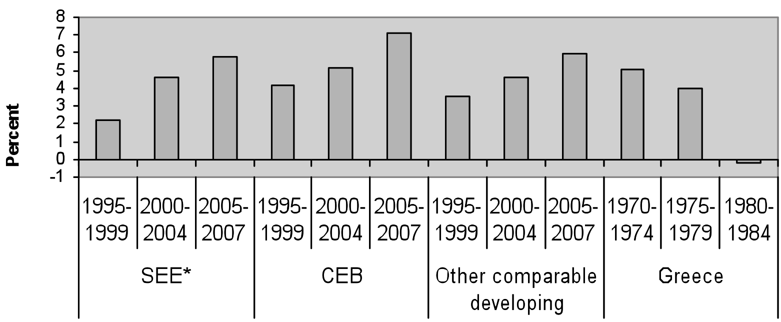
understand the home-grown factors that contributed to the susceptibility of SEE economies to adverse global influences.

In this chapter, I consider a related but distinct issue: does the size and nature of the recession in SEE during 2008-09 call into question the appropriateness of the direction of macroeconomic policies in SEEs during recent years (specifically to take on more of the features of the outward-oriented convergence model embraced even earlier in CEBs)? I start with a brief review of the growth history in the region. I then characterize the broad contours of the convergence model in CEBs (what I will call the Emerging Europe convergence model) which has been a model for many SEEs. After that, I explore some of the strengths and weaknesses that arose as that convergence model played out. I conclude by considering whether the severity of the crisis in SEE condemns the sustainability of the SEE convergence model or whether adjustments could make it more robust.

Recent Growth History in SEE

GDP growth in SEE during 6-7 pre-crisis years was high in comparison to earlier post-transition years. But looking at the full period since transition, the unweighted average of GDP growth rates in SEE was modest in comparison to that in CEB and even other developing countries with similar initial levels of per capita GDP (Figure 1).

Figure 1: Real GDP Growth in SEE and Comparators



Excluding Bosnia and Serbia and Montenegro for the first two periods and Montenegro for the third.

All countries (for which data are available) with PPP per capita GDP within $1000 of the average of SEE in 1995. Twenty-one countries comprise this group.

Source: IMF, WEO.

The dominant message from Figure 1 is that growth in emerging Europe and indeed other emerging countries at a similar per capita income level is quite co-linear. Apparently a common influence—presumably global GDP growth—is a critically important influence on the growth performance in these emerging countries.

A different take on the SEE growth rate comes from a comparison with Greece at a comparable stage of development. In 1970, per capita GDP in Greece (in PPP dollars) was roughly comparable to the 1995 average in SEE. In two of the three sub-periods since 1995, SEE growth exceeded that in Greece after 1970. One caveat, however, applies: except in the sub-period 1970-74, the global environment (as indicated by world GDP growth) was substantially less favourable in the sub-periods for which Greek growth is measured than in the period since 1995. Adjusted for this factor, SEE growth must be interpreted as modest.

By way of introduction to a consideration of the SEE convergence model, this snapshot of post-transition history points to two challenges for the future. SEE must both overcome a less than stellar performance since transition, and it must deal with the post-crisis world and the new issues it will bring.

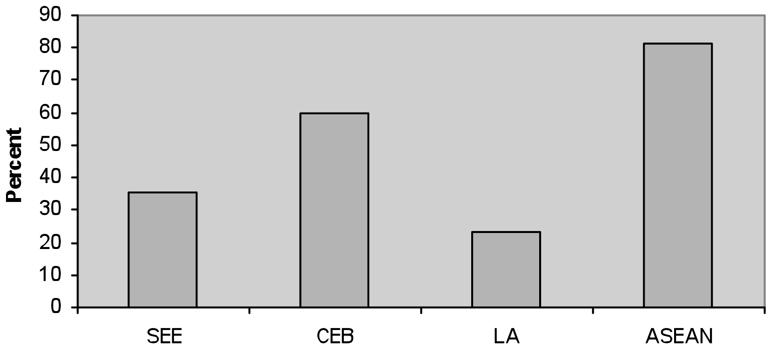
Distinguishing the Emerging Europe Convergence Model

For all countries with per capita GDP significantly below that in advanced countries, convergence requires crossing three basic hurdles. The first two involve raising labour productivity by increasing the amount and quality of capital matched to each worker and by making production more efficient through some combination of better management and better technical know-how. The third involves putting more of the working age population to work in productive activities. These objectives line the path to convergence regardless of the location, starting point or history of influences that held countries back.

But how individual countries go about achieving these goals differs quite significantly. Indeed, the path a country takes depends on a large number of choices about policies ranging from macroeconomic and financial to quite micro and regulatory, impacting everything from institutional structures to individual firm and household decisions. One important dimension of the choices from a macroeconomic perspective is how they affect or are affected by the nature of a country's integration in the global economy and financial system—an aspect of convergence strategies that carries with it both huge opportunities and potential pitfalls. The remainder of this paper focuses on this dimension of SEE convergence strategies in three main spheres.

The first is the openness to trade, a critical determinant of how foreign know-how is imported to domestic firms and of the nature of the competition firms face. Until the late 1970s (and even after that in many countries) most developing countries favoured an import substitution industrialisation model that effectively protected firms from foreign competition which was viewed as damaging to prospects for nascent industries. Gradually since then, the vast majority of countries have switched to a more outward, trade-intensive strategy in which exports are a driving force behind innovation, labour-absorption and production growth. SEE, like CEB before it, was late to this approach (embracing it only after the demise of central planning and even then with a considerable lag in most countries) and now have quite a bit in common with Asian emerging markets which pioneered the switch in strategy.

Figure 2.SEE and Comparators: Exports/GDP (average 2000-07)



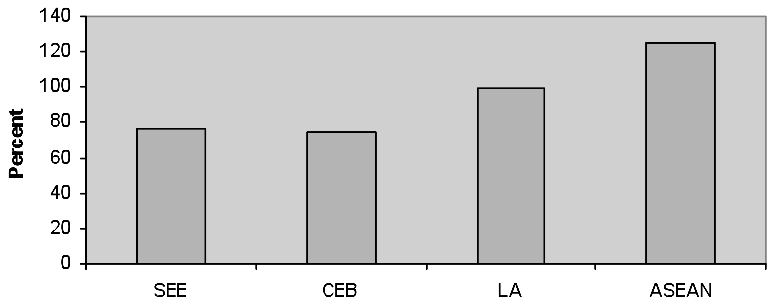
SEE excludes Bosnia and Montenegro; LA (Latin America) includes 19 countries form the region.
Source: Economist Intelligence Unit.

The second sphere is financial integration or more specifically how countries amass the savings needed to invest in order to raise capital-labour ratios. Asian countries, at one extreme, rely virtually predominantly on domestic savings by households and businesses, while both CEB and SEE rely to a far greater extent on foreign savings which enter their countries through capital inflows (foreign direct investment, portfolios inflows, and through banks, often foreign-owned) (Figure 3).[11] The difference has considerable implications for how and how closely countries must be integrated in the global financial system. For countries that invest fully or largely out of domestic savings, some degree of segregation from global financial markets through capital controls is possible. For countries that rely to a significant extent on foreign savings,

[11] See Schadler, Mody, Abiad and Leigh (2007) for an empirical assessment of the link between use of foreign savings and growth in Central and Easter Europe.

financial integration is an important feature of the convergence strategy. Typically, financial integration has many layers—freedom of capital flows across borders, exchange rate and currency arrangements, foreign exchange exposures, foreign bank presence, and public and private decisions about taking on external debt.

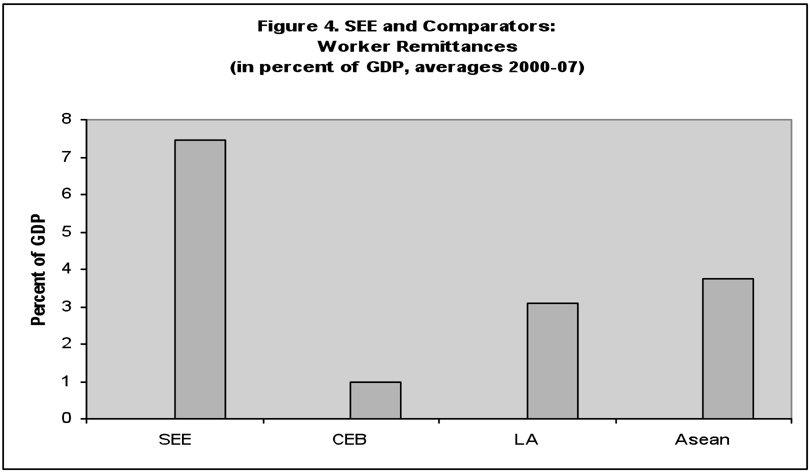
Figure 3. SEE and Comparators: Gross National Savings relative to Gross National Investment (average 2000-07)



SEE excludes Bosnia, Montenegro and Serbia. Latin America comprises 19 countries from the region.

Source: Economist Intelligence Unit.

The third sphere concerns the integration of domestic and global labour markets. In general, countries actually have little choice on this issue. Most face largely closed borders in advanced countries and therefore have broadly closed labour markets. CEB and SEE are different because they are part of or aspiring to be part of the European Union where, in principle, labour flows, freely across national borders. This means that for CEB and SEE countries that cannot generate adequate job growth at home, emigration can be significant. This has or could put upward pressure on wages relative the counterfactual of limited emigration, has or could make remittances a large part of foreign exchange earnings, and has or could impact the size of the resident working age population (Figure 4).



SEE excludes Serbia and Montenegro. CEB excludes Czech Republic and Slovenia. Latin America comprises 18 countries from the region (excluding Chile). ASEAN excludes Brunei, Laos, and Singapore.

Source: Economist Intelligence Unit.

In sum, while virtually all converging countries that have met with any degree of success in the past couple of decades have embraced economic integration at least in the area of trade, SEE (along with CEB before it) have taken the route of what I will call "super-integration." By virtue of their membership or aspirations of membership in the EU, they have molded their macroeconomic policies around integration with advanced countries that embraces financial (broadly defined) and labour market integration. This goes well beyond the integrationist policies of other converging economies. The question then is "How has this affected the strengths and weaknesses of their economic performance and do they need policy precautions that differ from those in other countries?"

Emerging Europe's Super-Integration and the Global Crisis

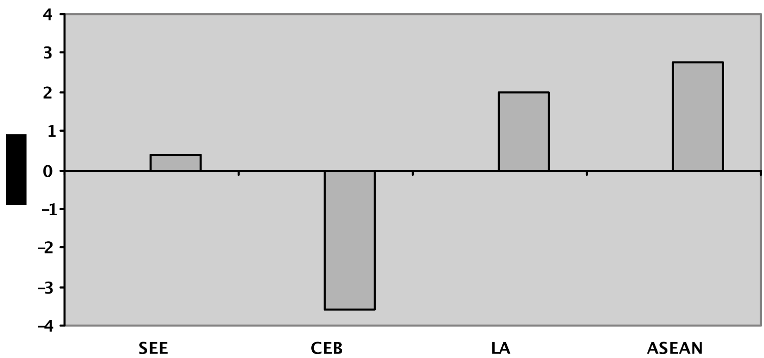
Super-integration confers many benefits on emerging Europe. Most obvious are the options for tapping into the opportunities in wealthy neighbouring countries for the export of goods and import of capital. Moreover, these opportunities are institutionalized through the process of acceding to the EU: trade policies are liberalized and unified, financial markets are integrated, transfers start to flow, and institutions are coordinated.[12] Consumption-smoothing and cross-border labour movements stand to improve inter-

[12] For an overview of the process of EU accession see Feldman and Watson (2002). For an examination of the macroeconomic effects of EU transfers in the new members see Allard et al (2007).

temporal welfare through channels beyond the reach of other converging economies, while common institutions and legal structures give emerging Europe a significant edge relative to other converging economies as an investment platform. Also, countries that have acceded to the EU or have travelled a significant way down the road toward accession have enjoyed an "EU halo" effect on sovereign debt spreads: spreads relative to German bunds averaged some 100-150 basis points lower during 2003-07 than predicted by a well-performing econometric model. And, though the gap narrowed during the crisis, even in 2008 it remained on average some 50 basis points.[13] Emerging Europe's super-integration might be seen as the paragon of globalisation.

But the crisis has place in sharp relief weaknesses or risks that accompany these benefits. SEE (and to an even greater extent CEB) suffered large contractions in GDP in 2009 by comparison to emerging markets in other regions. (Figure 5) This outcome was certainly influenced by the fact that among advanced countries, Western Europe was hardest hit in the crisis.

Figure 5. SEE and Comparators: Impact of the Crisis (average change in GDP, 2008-09)



Source: IMF, World Economic Outlook, October, 2009 estimates and projections.

Goods and Services Trade

It is uncontroversial that for countries highly integrated in global goods and services markets, the seizing up of export markets was a major source of output losses. EBRD (2009) in its very interesting assessment of the influences of the crisis on emerging Europe finds in a regression analysis

[13] See Luengnaruemitchai and Schadler (2007).

that export growth (well-illustrated in Chapter 1 of this volume) explains a substantially larger part of the GDP contraction in emerging Europe than any other factor—greater openness, larger contraction. Not surprising, and highly relevant to emerging markets everywhere. This finding lends strength to the view that the severity of the crisis in emerging Europe significantly reflected neighbourhood effects together with the emphasis on export activity common to successful emerging markets everywhere.

But the question of whether super-integration compounded the effect of the crisis remains. Needless to say, it is not easy to distinguish the effects of different aspects of super-integration, in part because they are quite interlaced and in part because the integration was mainly with Western Europe which among advanced countries suffered the most during the crisis. Nevertheless, there is scope for considering two key macroeconomic aspects of super-integration—financial and labour markets—in turn.

Financial Markets

Several approaches to measuring how financial integration might have exacerbated the impact of the crisis in emerging Europe lead to the same conclusion: more financial integration, larger contractions of GDP. In the quite thorough investigation in the 2009 EBRD Transition Report, a panel data regression analysis of factors underlying the drop in GDP points clearly to negative effects of the slowdown in cross-border lending.

Less clear is what was the s*pecific* nature of the vulnerability from financial integration? Yet this is important for considering policy changes in the post-crisis period. Several possibilities suggest themselves.

> **Presence of foreign banks.** The EBRD results suggest that countries with larger foreign bank ownership (by asset share) were actually *less* affected by the crisis than were countries with larger domestic bank ownership.
>
> **Adverse effects on market confidence from high levels of external debt.** The 2009 Transition Report finds a relationship between output contractions and gross external debt. One flaw in this analysis, however, is that it is based on gross external debt ratios, and it is questionable whether it would stand if the net foreign position (i.e. including FDI) or a (more suitable) measure of net external debt were used.
>
> **Foreign exchange exposures.** Again, EBRD results suggest a relationship, though not a strong one. The measure is obviously flawed by the absence of information on the extent

to which foreign exchange exposures had implicit hedges.

Role in fuelling credit booms which in turn caused asset bubbles. This influence appears to be most convincingly backed by the data. Defining a credit boom is not straightforward, but as the Transition Report shows the negative correlation of GDP performance during the crisis with growth of credit to the private sector during the three pre-crisis years is strong compared to those of GDP performance with foreign exchange exposures, external debt and loan-deposit ratios.[14]

A distinctive aspect of CEB and SEE financial market integration with Western Europe is the commitment to eventual currency integration. As with other aspects of super-integration, the commitment to euro adoption is a strength (the eventual elimination of the risks of individual currencies is most likely the main factor behind the "EU Halo" effect). It has also proved to be the source of uncertainty.

With an erratic, but ongoing stream of new information on when and in what circumstances new members will adopt the single currency, euro adoption expectations create dilemmas for both markets and policymakers. What seems right—in terms of market pricing, public and private FX exposures, and policies—in one constellation of expectations can prove wrong if events precipitate a revision of expectations. For example, for countries that were to adopt the euro in a medium-term—say 5-7 year—horizon, it was perfectly rational and in fact stabilizing for residents of emerging Europe to take on foreign currency exposures, for markets to set interest rate spreads below those in non-European emerging markets, and for central banks to hold official reserves at low levels in comparison with other emerging markets. But if euro adoption is unlikely until the distant future, all these behaviours entail costly risks. These risks were exposed by the crisis and inevitably worsened volatility as markets reappraised prospects for euro adoption.

Labour Markets

Labour market integration is a less understood, but potentially critical issue for the emerging Europe convergence model. Study of the issue is hampered by limited data, the fact that many restrictions on immigration from new members to most old members will apply until 2011, and the very wide range of predictions on labour flows that can be drawn from migratory patterns in

[14] See Charts 2-15 entitled "Cumulative output decline and macro-financial fundamentals, EBRD(2009).

other parts of the world. Broadly, the evidence to date suggests that emigration from the new members has been smaller than had been expected (or feared in the old members), that net emigration has been even less than gross as new members have seen inward migration from countries further to the East, but that some countries have seen substantial outflows (over 3 percent of the working age population in Lithuania for example).[15] At the same time, some of the SEE countries that are not even members of the EU, such as Macedonia, Bosnia and Albania, have extremely large outward labour migration. The evidence on the impact of the crisis on migration is not yet available. Even more important is the question of how migration will play out after the direct effects of the crisis are past

Though most emerging markets experience some outward migration, few if any are as open to migration as emerging European countries. This openness is consistent with the optimal currency area criteria (OCA). Yet the conceptual foundations of the OCA are built around the assumption that the countries concerned have roughly similar levels of wages or per capita GDP. In these circumstance, the importance of labour mobility stems from the need for an equilibrating mechanism in the event of asymmetric shocks when monetary policy/the exchange rate is not available as a stabilizing instrument. It is less clear that super-integration in emerging Europe extending to open labour markets is necessarily good for convergence. Why?

First, integration through the EU helps convergence largely because it facilitates the flow of capital from high wage/high saving old members to lower wage/lower saving new members. However, if the volume of such flows is inhibited by poor institutions (an important consideration particularly in some SEE countries), this channel loses some effectiveness. Labour instead flows West. Though resulting remittances are a positive, employing labour at home is essential for the vibrancy, scale and diversification of the domestic economy. Drops in the size of the resident labour force during 2003-08 in about half of CEB and SEE countries are worrying in this regard.

Second, early results reported in studies reviewed in Kahenec and Zimmerman, suggest that migration between new and old members of the EU is driven mainly by income differentials and opportunity. While the resulting flows have not been surges and they have been partially offset by labour reflows and inflows from the East, they must put upward pressure on wages in the East, hurting competitiveness. The issue here is less competitiveness vis-à-vis old members, but rather vis-à-vis other emerging markets where outward migration is more constrained so that downward pressure on wages is sustained.

[15] Kahanec and Zimmerman (2008) present a good overview of studies on intra-EU migration since enlargement.

Third, the importance of relative wage levels, or more precisely relative real unit labour costs, goes beyond competitiveness and may help explain the difference between domestic saving rates in European emerging markets and those in other emerging markets. In a Kaldorian growth model, a key determinant of private savings is the distribution of income between wages and profits (Kaldor (1970)). Savings rates are inversely related to labour's share of value added, because wage-earners close to subsistence income levels save a smaller proportion of their income than do profit makers. Thus, relatively low domestic savings rates in emerging Europe may be the result not just of financial integration and its facilitation of consumption smoothing, but also of the influence of real unit labour costs above those in other emerging market countries. In other words, to the extent that labour market integration places upward pressure on wages, it may also be contributing to the relatively low level of domestic savings.

These three considerations must be seen against considerable evidence that labour mobility is good for growth in the EU as a whole.[16] Better matching of skills to productive requirements as well as the reduction in un- or underemployment that come with labour mobility are system-wide benefits. But as countries continue further down the road of super-integration involving full labour mobility, they must be aware of the country level risks if brain drain and general outward migration are significant.

Safety Valves in the Emerging Europe Convergence Model

It would be wrong to consider the risks inherent in the emerging European convergence model without considering some of the impressive safety valves it incorporated in the years leading up to the crisis. First, a legacy of reasonably low public deficits in most countries meant that pre-crisis government debt was for the most part low, providing often-significant room for manoeuvre during the crisis. True, most countries have seen sizable increases in their debt during the crisis, but having started from moderate levels, the burden of clawing these back will not be nearly as onerous as it has been in preceding emerging market crises in other parts of the world.

Second, about a third of the countries among CEB and SEE countries have sufficient exchange rate flexibility that they have been able to gain competitiveness when they needed it. Even more tellingly, most of the countries with fixed or nearly fixed exchange rates have shown the early signs of significant downward wage flexibility. It is too early to tell whether this adjustment will be adequate to restore competitiveness in countries where pre-crisis booms pushed wages to excessive levels. First signs are pointing in the right direction.

[16] See again references in Kahanec and Zimmerman.

Third, the EU halo—that unexplained compression of spreads after accounting for the impact of domestic and global conditions—has diminished, but has not vanished. Lower spreads than can be explained by conventional determinants mean that several emerging European countries retain some ¼-½ percentage point advantage in financing costs relative to emerging markets in other parts of the world with similar fundamentals.

Post Crisis Super-Integration: What Needs to be Done?

The integration of the new and prospective members of the EU with the advanced countries of Western Europe has gone too far to consider any rolling back. A model of super-integration will remain a fact of life. But rethinking the safety valves makes sense. The first step is to consider most likely vulnerabilities over the next decade; the second is to design policies to address them.

Are yesterday's vulnerabilities tomorrow's vulnerabilities?

Uncertainties about the global environment loom large, and how these turn out will have large implications for how fast and aggressive policy changes will have to be. A critical mistake would be to focus policy adjustments on the missed or underestimated vulnerabilities of the pre-crisis period, when the new vulnerabilities take on new shapes. Thus, in fashioning adjustments to the emerging Europe convergence model, six key questions about the post-crisis environment need to be answered.

> **How quickly and strongly will demand in Western Europe pick up**? Signs of life are certainly blooming in Western Europe, but the pace of the pick-up seems to be lagging that in the United States. And, while the enormous scope for convergence in CEB and SEE countries may allow some de-coupling with Western Europe, this would require aggressive penetration of outside markets if the Western European recovery is relatively weak.
>
> **How quickly will financing inflows resume?** Two views are currently competing for dominance: the first holds that early signs of a resumption in the appetite for emerging market debt will be sustained; the second, drawing on the experience after the Asian crisis when foreign bank exposures fell for five years after the onset of the crisis, foresees a only slow rebound.
>
> Even if inflows resume, **will the appetite for public debt meet the much higher supply over the next few years**. It is

hard to see investors flocking to emerging market public debt if they start to get cold feet about the triple A-rated public debt of advanced countries. This could mean that fiscal adjustment will have to be far faster than would be ideal.

Have gains in competitiveness in many countries been strong enough? In the fixers the question will be whether wages need to fall further, while in the floaters questions about competitiveness would constrain interest rate increases. More broadly, where is the value of the euro headed? With many CEB and SEE currencies fixed to the euro and others strongly influenced by it, the value of the euro on international markets will be key to their competitiveness outside Europe.

Will outward labour mobility level off, resume or even balloon after the EU member derogations on open borders end in 2011? At the moment labour migration has been muted or, for many countries reversed owing to weak labour demand in the West, but if that demand were to pick up, outflows could impede the wage adjustment that should occur.

Whither euro expansion? Two concerns here. First, will the Greek crisis and stresses around the discussion of establishing a European Monetary Fund introduce new scepticism on the part of existing members about euro area expansion. This is not to say that the Maastricht criteria could be changed. But the mood surrounding the discussion of euro adoption is important for prospective members, for whom hard policy choices are typically needed. Second, will aspiring member countries lose interest? In other words, will progress toward euro adoption require simply steadfast efforts to meet the Maastricht Criteria, or will it require also more aggressive efforts to increase policy and public support for the euro?

Revamping the European Convergence Model

Answers to the key post-crisis questions will evolve slowly, but must inform policy choices going ahead. In the meantime, four types of adjustments to the convergence model in the environment of super-integration need to be considered in an effort to address vulnerabilities revealed in the past and likely for the future.

First, policies must be tailored toward competitiveness in the markets most likely to hold growth prospects for SEE countries. The crisis has certainly highlighted the problems of export concentration and its potential to derail growth in even countries with the strongest fundamentals like Slovakia and Czech Republic. There is certainly more scope for integrating further in supply chains feeding demand in Western Europe and generally increasing penetration of Western European markets. But whether this potential will prove adequate for nurturing rapid growth particularly of the less developed industrial structure of SEE will depend importantly on the strength of the recovery in Western Europe. As a safety valve, SEE will need to position itself to broaden its export base in terms of products and markets outside the EU.

The critical macroeconomic contribution to this effort will be preserving and expanding gains in competitiveness achieved during the crisis need. For fixers this is likely to require further drops in public sector wages in order to set an example for and directly influence private labour demand. For floaters, the focus will need to be on both wage developments and containing what is likely to be strong pressure for appreciation. Realigning the fiscal-monetary policy mix to focus strategies for exiting crisis-induced easing will require early and decisive fiscal tightening so that interest rates can remain low. For both fixers and floaters, now is the time to lay the base through structural reform for faster productivity growth that will keep workers at home when labour markets pick up in the West.

Second, and reinforcing the shift in the monetary-fiscal policy mix, fiscal deficits will need to be clawed back in a timely fashion. SEE countries will not have anything close to Greek-style public debt burdens at the end of the crisis. But most will have deficits and rising debt that are unsustainable. Ideally they would be able to hold the line on spending and grow out of these difficulties, but much damage could be done before that process sets in. Moreover, should global interest rates rise and recovery in Western Europe be relatively weak, achieving debt- stabilizing growth could be delayed. Though most SEE countries were able to pursue reasonably contained fiscal policies before the crisis, none had established a forceful fiscal rule to help anchor policies in more difficult circumstances. In the uncertain global environment that lies ahead, fiscal adjustment would be best supported by having a public debate on a viable fiscal rule, establishing such a rule, and then sticking to it.

Third, decisions need to me made on how to manage capital inflows when they resume. The horizon for this development is fraught with uncertainty, but planning now is essential. The IMF recently floated tentative support for various ways of putting sand in the wheels.[17] Whether these would be permissible given EU commitments needs to be resolved now.

[17] See Ostry et al (2010).

The record on such sand-in-the-wheels policies is mixed at best—possibly they change the size and composition of inflows but probably for short periods. The problem facing emerging Europe with its super-integration needs a stronger and more permanent instrument. If emerging Europe is to continue to depend on large inflows from richer Western European countries, those inflows must be channeled into productive activity that does not feed bubbles in prices of non-traded goods. Now, most emerging European countries are so open that about the only truly non-traded activity is real estate and construction. Inflows into consumer credit could also be a threat to stability. If the channels for funds flowing into these activities can be narrowed directly—not through raising taxes on inflows, but rather by taxing underlying transactions (such as taking out second mortgages or having credit card balances above a prescribed limit) it should be possible to keep speculative activity below thresholds where it turns into manias and panics. It is possible to design taxes to address these problems but it takes time and careful thought. This task must be approached soon.

A fourth area that must be addressed in the post-crisis strategy is euro adoption. This is a critical piece of the European convergence model. Effectively, super-integration without going the whole distance to a single currency leaves an enormous gap with attendant scope for undue risks. It is an inescapable truth that cross-border financial flows between countries with different currencies involve exposure to foreign exchange risk on the part of the receiving or sending country. Large-scale use of foreign savings by emerging Europe—which given relative rates of return in any reasonably sound institutional setting is inevitable in a model of super-integration—will entail substantial exchange rate risk until the single currency is adopted widely.

Thus, for either existing or aspiring members to lose the drive to see this critical component of super-integration through would leave a large and destabilizing hole in the model itself. While sooner would be safer than later, the even more important dimension is the depth of commitment to get the job done. Muddying the signals on the determination of the existing members to embrace well-prepared applicants or half-hearted efforts of applicants to transparently and convincingly meet especially the fiscal criteria will simply make the existing confusion in the market about the future of euro expansion worse. Falling back on the hope that a convergence model based on super-integration can be sustained indefinitely without euro expansion is placing a great deal of faith in a low-probability outcome.

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Chapter 3 - Financial market aspects of the crisis in South East Europe

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Introduction

In 2009/10 Europe celebrated twenty years since the fall of the Berlin Wall. Although twenty years of political transition was duly celebrated, twenty years of economic transition was not, amidst the global financial and economic crisis. The crisis challenged the growth model of countries in South East Europe, which relied on foreign financing of high levels of investment as domestic savings were insufficient to fund investment demand. As there was ample and cheap capital available in the years preceding the crisis, this growth model worked well and its vulnerabilities did not cause major concern.

High investment levels in the transition period did not help much to improve the competitiveness of the countries, as all recorded a deficit in their current account. In fact in 2007, just before the crisis, most of the SEE countries (except for Croatia, FYROM and Turkey) recorded a double-digit deficit in their current account. Those deficits were comfortably covered by the inflow of foreign capital either in the form of non-financial sector FDI or in the form of bank capital coming from parent banks to their local subsidiaries. Another form of capital inflows were remittances from abroad as sizeable parts of the workforce of SEE countries immigrated to EU countries.

The slowdown of capital inflows led to a decline in the lending that had been fuelling consumption, and a decline in FDI, that had been fuelling investment. The decline in GDP for 2009 was as remarkable as the real growth rates achieved since 2000.

In a post-crisis economic recovery the cost of capital is expected to remain at high levels for at least a few years. At a higher cost of capital, FDI will be less than previously and bank capital flows will decline giving rise to lower

GDP growth rates. This will challenge the existing growth model of the SEE countries. This may require an adjustment in external imbalances, supported by deeper structural reforms on labour and product markets.

Macroeconomic background - convergence performance

In the early 1990's, almost all the SEE countries embarked on transforming their economies from centrally planned to market economies. Centrally planned economies were characterised by "planning by quantities". This means that emphasis was given to producing output without concerns for demand or costs of production. Kornai (1994) identifies that the two key elements of the transition to a market economy were the introduction of demand and cost considerations in resource allocation. These involved price liberalisation to introduce demand considerations and enforcement of hard budget constraints to introduce cost considerations. The enforcement of hard budget constraints entails the abolition of subsidies, privatisation (as a means to internalise losses and, of course, profits) and the creation and liberalisation of a financial market.

During the transition process efficient resource allocation was sought through the restructuring within firms, by means of new investment and labour rationalisation and reallocation of resources from old to new activities, by means of closures and bankruptcies of old and the establishment of new enterprises (Blanchard (1997). Reforming institutions towards a market economy was found (De Melo et al. (1997) to improve the ability of transition countries to effectively reallocate resources.

In the initial years of transition, output declined in virtually all transition economies. Fischer and Sahay (2000) found that both stabilisation policies and structural reforms (particularly privatisation) contributed to output recovery after the initial decline. The countries that insisted in reforms soon recovered with the ones that implemented reforms at a faster pace to recover earlier.

Since 2009 there has been a clear slowdown in introducing reforms (EBRD (2009). This is due to the fact that dealing with the financial and economic crisis is the priority of policy makers in the SEE countries and has, thus, dominated their agenda. Privatisation reforms require investors' interest, which is low during the crisis.

The financial system

The financial system of SEE countries can be characterised as bank-centric. This is in part explained by the absence of capital markets in planned economies. The functioning of credit institutions had to be reoriented in the context of introducing a market economy. The analysis of financial market aspects of the crisis, therefore, focuses on the banking sector of SEE countries.

Several clearly discernible trends are evident in the evolution of the banking sector in SEE countries. In the first place, a tendency for increasing concentration is apparent. Such concentration has, generally, a positive effect on banks' profitability and efficiency[18]. In addition, foreign owned banks dominate the market (in some countries their market share exceeds 90%). In the first place, efficiency was improved as foreign-owned banks utilised risk-management techniques. Finally, conformity to international standards with regards to regulation and supervision of the banking industry has been progressing.

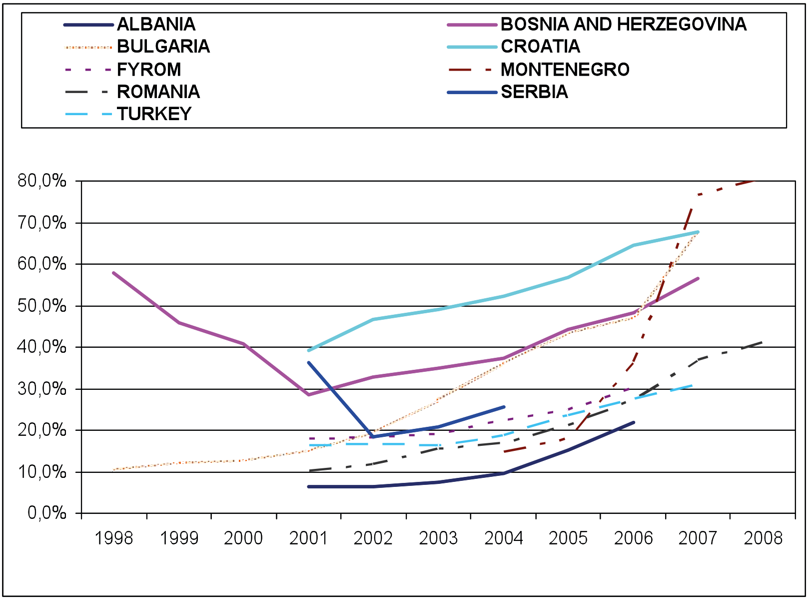
Degree of financial intermediation

Since the new Millennium, the degree of financial intermediation is increasing in all countries. The time path of the ratio of credit to GDP (Chart 1) provides evidence of this trend. The only exception to the continuous increase in the private credit/GDP ratio occurred in Serbia in 2002, when a massive restructuring of the banking sector took place[19]. Croatia, Bulgaria, Bosnia-Herzegovina and Montenegro have witnessed the most notable credit expansion. In fact in Montenegro the private credit/GDP ratio reached approximately 80% in 2008. The corresponding ratio for the Euro Area, however, remains much higher (140% in 2008), implying a strong potential for further financial intermediation in all countries in the region.

The growth process led to increasing household incomes, which enabled the development of consumer lending with additional spill over effects to the corporate sector. The provision of credit boosted demand for consumption and durables. The pace of financial intermediation deepening, however, far exceeded GDP growth contributing to vulnerabilities (Kraft and Jankov 2005, Winkler 2009).

[18] Simona (2007) analyses the motives behind M&As in the region of South Eastern Europe and identifies market power, funds surplus and market penetration as the primary ones for acquirer banks.
[19] The four largest state-owned banks were liquidated, having been greatly insolvent, and a number of foreign owned banks was established (NBS Annual Report 2002).

Diagram 1: Credit to GDP ratio 1998-2008

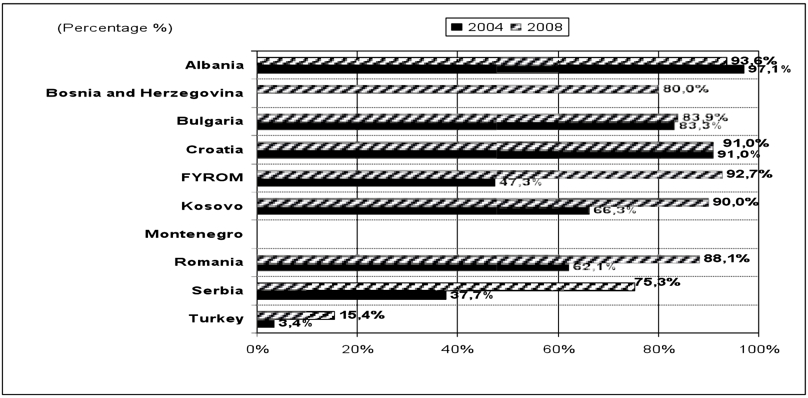


Source: IMF and Bank of Greece.

Foreign bank presence

With the notable exception of Turkey, the banking sector in South East Europe is dominated by foreign-owned banks (see Chart 1, and Sanfey's contribution to this volume in Chapter 1). The share of foreign-owned banks in total banking system assets stands in the range of 75-95%. In contrast, in Turkey the share of foreign-owned banks remains at15% of banking system assets.

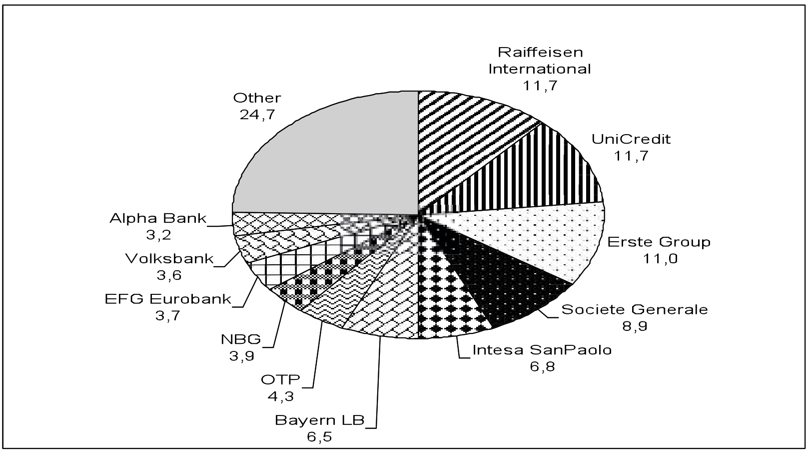
Diagram 2: Share of foreign-owned banks in total banking system assets



Source: National Central Banks.

The most important investors in SEE banking are European Union banking groups, mainly from Austria, Italy, Greece, France and Germany (chart 2). The local branches and subsidiaries can rely on parent support (e.g. funding, capital, systems and controls) to manage growth, as well as weather shocks. The flip side is that they are also vulnerable to difficulties encountered by the parent groups, which may spill over to their operations in the region.

Diagram 3: Market share in SEE countries in % of banking sector assets



Source: National Central Banks and company data.

Vulnerabilities and channels of contagion

Decline in global trade flows and FDI

As underlined by Sanfey in Chapter 1, SEE countries have been consistently running current account deficits, which tended to increase over time. Current account deficits, however, were financed by foreign direct investment and private lending inflows.

Table 1: Current account balances 2000 – 2009 (in percent of GDP)

Country	2000	2001	2002	2003	2004	2005	2006	2007	2008 est.	2009 proj.
Albania	-4.7	-7.4	-9.5	-7.0	-5.8	-8.7	-11.3	-10.6	-15.1	-14.5
Bosnia and Herzegovina	-16.4	-18.8	-19.3	-19.5	-16.4	-16.8	-8.0	-12.2	-14.7	-9.6
Bulgaria	-5.6	-5.9	-2.0	-5.1	-6.8	-12.2	-17.9	-25.4	-25.2	-12.6
Croatia	-2.5	-3.2	-7.5	-6.3	-4.4	-5.5	-6.9	-7.5	-9.4	-8.5
FYROM	-1.9	-7.1	-9.5	-4.0	-8.4	-2.7	-0.9	-7.5	-12.7	-11.9
Kosovo										
Montenegro	-4.5	-14.6	-12.3	-6.8	-7.2	-8.6	-24.7	-29.4	-33.6	-22.8
Romania	-3.6	-5.8	-3.4	-5.8	-8.4	-10.2	-11.8	-14.4	-12.3	-6.0
Serbia	-2.2	2.5	-4.3	-7.8	-13.9	-8.7	-10.1	-15.7	-17.2	-12.9
Turkey	-3.7	1.9	-0.3	-2.5	-3.7	-4.6	-6.0	-5.9	-5.7	-3.0

Source: EBRD (2009).

The global financial and economic crisis resulted in a decline of international trade flows. The sudden drop in imports suggests a significant decline in consumption and investment. In consequence, current account balances of SEE countries narrowed in 2009 and continue to do so in 2010.

Table 2: Foreign direct investment 2000 - 2009*

Country	2000	2001	2002	2003	2004	2005	2006	2007	2008 est.	2009 proj.
Albania	143	207	135	178	324	258	315	647	844	650
Bosnia and Herzegovina	146	119	266	382	708	608	718	2,088	1,003	600
Bulgaria	998	803	876	2,070	2,879	4,005	7,583	11,433	8,472	5,775
Croatia	1,105	1,398	552	1,927	732	1,551	3,194	4,736	4,576	2,731
FYROM	175	441	105	117	322	94	424	700	612	300
Kosovo										
Montenegro	n.a.	10	84	44	63	482	585	717	805	638
Romania	1,051	1,154	1,080	2,156	6,368	6,587	10,957	9,629	13,519	4,900
Serbia	50	165	475	1,365	966	1,550	4,264	2,523	2,717	1,400
Turkey	112	2,854	957	1,252	2,005	8,967	19,065	19,940	15,633	7,000

*** Net flows recorded in the balance of payments in USD million). Source: EBRD (2009).**

SEE countries are savings constrained so they have to rely on foreign capital inflows to finance investment. Up to 2007, foreign direct investment was steadily rising in SEE countries. In 2008/09, however, foreign direct investment in SEE countries declined dramatically and has not recovered since.

External funding

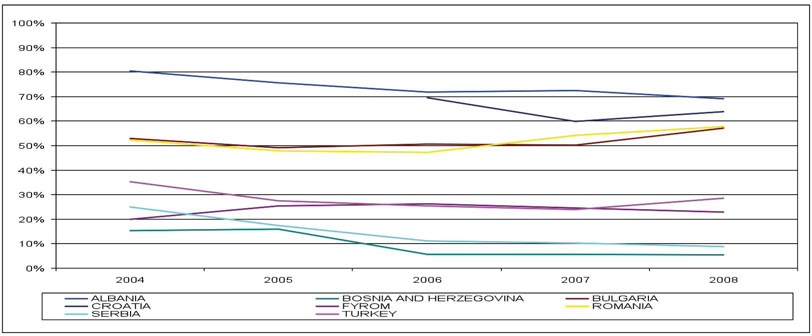
A distinctive feature of financial deepening in SEE countries has been their reliance on external funding. In the banking sector this took the form of parent funding towards local subsidiaries.

The strong presence of foreign banks, however, entails direct dependence of SEE countries from financial developments in EU countries through the need for uninterrupted capital flows. In the context of the current crisis, however, it seems that the reliance on external funding from parent banks did not function as a destabilising factor. Parent banks committed to keeping their exposure in the region.

FX lending

Lending in foreign currency (FX lending) is a common feature of most SEE countries. A number of factors, such as differentials in interest rates between loans in domestic and foreign currency, exchange rate regimes (some of the countries have relatively stable exchange rates against the euro, encouraging, thus, borrowing in euro), have contributed to the expansion of FX lending in SEE countries.

Diagram 4: FX loans to total loans



Source: National Bank of Romania, Central Bank of the Republic of Turkey and Raiffeisen Research.

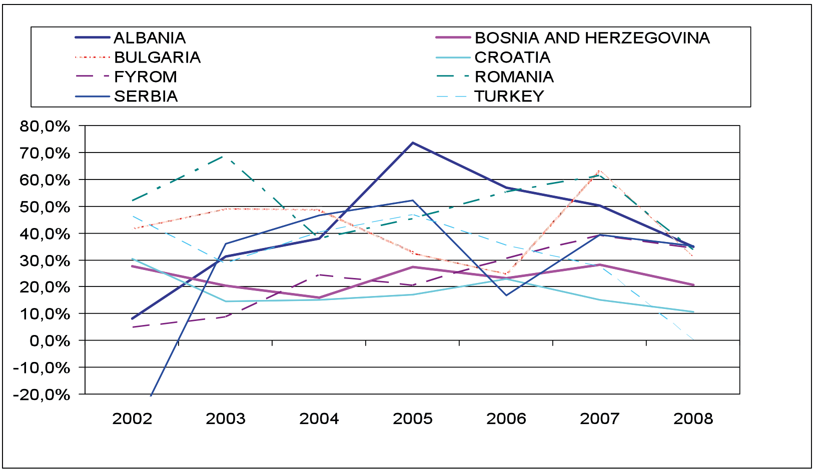
In Albania, Bulgaria, Croatia and Romania, FX loans accounted for more than 50% of total loans. In 2008, on the onset of the crisis, FX lending as percentage of total loans declined compared to 2007 in Serbia, Bosnia and Herzegovina and Albania. The increase in the share of FX lending in Turkey and Romania may be due to the depreciation of currencies in 2008 (over 20% and 10%, respectively).

GDP deceleration (or even contraction)

SEE countries have demonstrated remarkable growth dynamism over the past years. Domestic consumption (fuelled by credit expansion) and gross fixed capital formation (fuelled by foreign direct investment) were the main drivers of GDP growth. When capital inflows ceased due to the crisis, GDP performance turned negative.

All countries in the region experienced a credit expansion slowdown due to decreased demand for credit on the one hand and banks' tightening of credit standards on the other (Eller *et al* 2009). Credit expansion (i.e. the rate of change of total amount of outstanding loans in local currency) is depicted in Diagram 5.

Diagram 5: Credit expansion 2002 - 2008

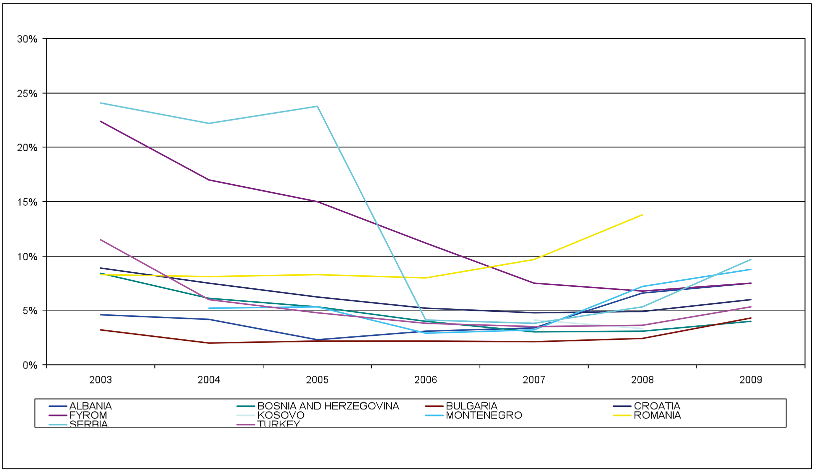


Source: IMF and Bank of Greece.

Increase in NPLs

The NPL ratio (non-performing loans as percentage of total outstanding loans) of almost all countries of the region declined until 2007, as depicted in Diagram 6. As from 2008, however, the NPL ratios are rising for all countries in the region, with the exception of FYROM.

Diagram 6: NPL ratios, 2003-2009



Data for 2009 were not available for Kosovo and Romania. Most recent data for Croatia, Serbia and Bosnia and Herzegovina refer to June 2009 while most recent data for FYROM, Albania, Bulgaria and Montenegro refer to March 2009 and for Turkey refer to August 2009.

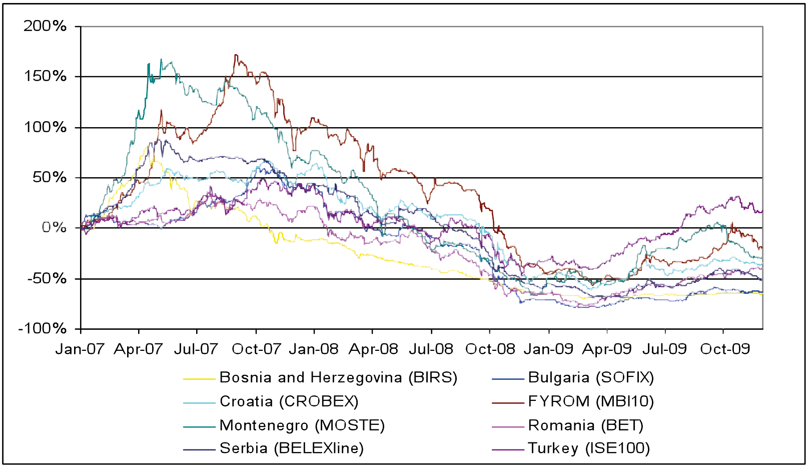
Source: IMF and Central Bank of the Republic of Kosovo.

As depicted in Diagram 5, credit growth decelerated since 2008. This is due to the fact that credit expansion came practically to a halt in the last quarter of 2008, following the Lehman Brothers collapse. In the first half of 2009, credit growth to the private sector in SEE countries is clearly below the pre crisis levels.

Capital markets

Stock market indices started to decline across the region in August 2007 when the US subprime mortgages crisis emerged triggering investors' global risk aversion. By Q3 2008 stock markets lost 40% - 60% of their capitalisation compared to January 2007. Since April 2009, stock market indices markedly rebounded in expectation of upside economic surprises.

Diagram 7: Stock market indices performance (January 2007 = 100; January 2007 – September 2009)



Source: Bloomberg.

Sofix Index, which includes the 20 most important Bulgarian enterprises, lost 86.7% from October's 2007 highs but it has already rebounded 84.7% after February's 2009 low levels. BET index, which includes the 10 most significant Romanian companies, tumbled 82.6% from July 2007 to late February 2009, when it reached this year's low. Serbia's major stock index BELEXline decreased by 83.2% in the period May 2007-April 2009 and recovered 83.9% in the period April 2009-September 2009.

Similarly, FYROM's MBI10 index lost 84.1% for the period August 2007-March 2009 and rose since by 94% at end of September 2009. CROBEX index, which includes 24 Croatian companies, declined 76.6% from its October 2007 level and rose by 74% in the period March 2009-September 2009. Finally, MOSTE index, which is the major index of Montenegro stock market, plunged 87.6% after May 2007 and soared by an amazing 210% in the period December 2008-September 2009.

Domestic policy responses

Declining world trade led to reduced economic activity, which in turn, contributed to a loss of tax revenue. This revenue shortfall has brought about general government deficits to widen in 2009 in most countries.

Table 3: General government balances (in percent of GDP, 2000-2009)

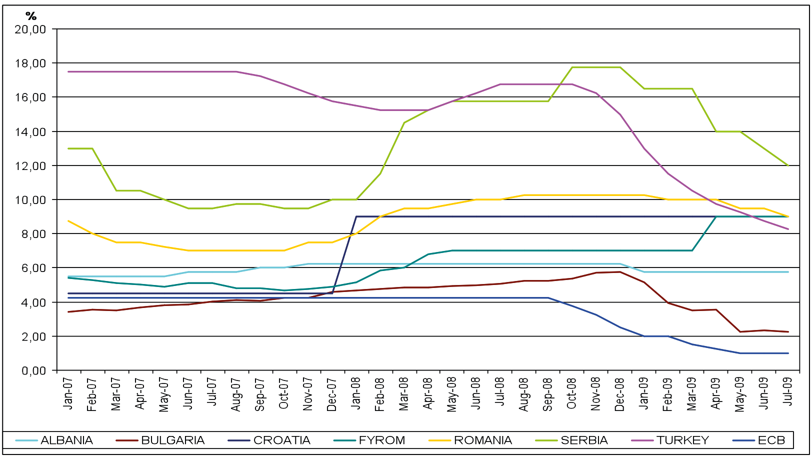
Country	2000	2001	2002	2003	2004	2005	2006	2007	2008 est.	2009 proj.
Albania	-7.6	-6.9	-6.1	-4.9	-5.1	-3.5	-3.3	-3.5	-5.7	-6.3
Bosnia and Herzegovina	-4.7	2.2	-4.2	2.3	1.6	2.2	2.2	-0.1	-3.0	-4.0
Bulgaria	-0.5	1.9	0.1	-0.9	2.2	1.9	3.3	3.5	3.0	-0.1
Croatia	-7.5	-6.8	-4.9	-4.8	-4.0	-3.5	-3.1	-2.5	-1.4	-3.3
FYROM	2.5	-6.3	-5.7	-0.6	0.4	0.3	-0.5	0.6	-1.0	-2.8
Kosovo					-4.5	-3.0	2.4	7.0	n.a.	n.a.
Montenegro	-4.0	-2.0	-1.9	-3.1	-1.9	2.1	4.2	6.4	1.5	-3.0
Romania	-4.6	-2.1	-2.0	-1.5	-1.2	-0.8	-1.6	-3.1	-4.9	-7.3
Serbia	-0.9	-6.3	-3.2	-1.1	0.9	1.0	-1.6	-1.9	-2.4	-4.5
Turkey	-8.0	-12.1	-11.4	-8.8	-5.4	-1.3	-0.8	-1.7	-1.9	-7.0

Source: EBRD (2009) and European Commission (2009).

Revenues shortfall and financing constraints left limited scope for fiscal stimulus. By September 2009, Albania, Bosnia and Herzegovina, Croatia and FYROM had all adopted budget revisions. The general government debt of all SEE countries was less than 60% of GDP in 2007 (Darvas, 2009).

Monetary and exchange rate policy

Diagram 8: Key policy rates



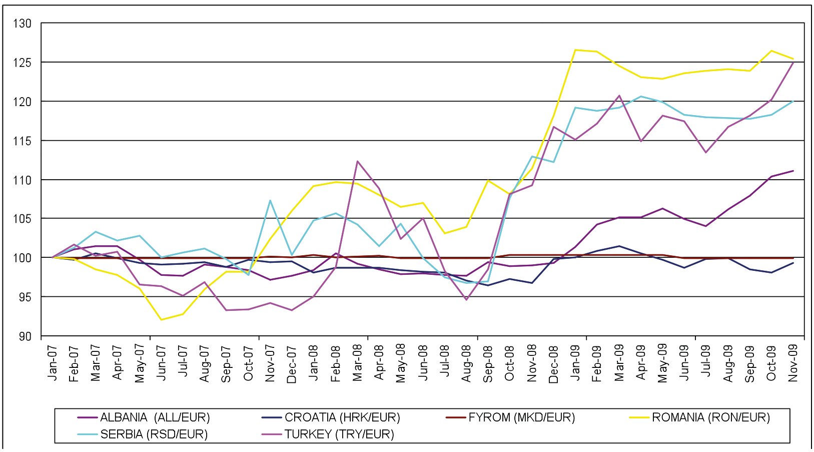
Source: Bloomberg and National Central Banks.

The burden of dealing with the financial and economic crises fall on monetary policy. Both key policy tools available (discount rates and reserve requirements) were used but, as different policy objectives had to be served, the direction of monetary policy in the region was heterogeneous. Kosovo and Montenegro use the euro as the de jure legal tender. As a result they follow the ECB monetary policy and have no control over the euro discount rate. Bosnia and Herzegovina and Bulgaria have their currencies pegged to the euro while FYROM maintains a fixed exchange rate against the euro. For Albania, Croatia, Romania, Serbia and Turkey discount rates had to reconcile liquidity and exchange rate considerations.

As shown in Diagram 8, most countries responded to the US subprime crisis in Q4 2007 with a hike in their key policy rates. The ECB rate cut in September 2008 was followed only by Serbia and Turkey and with a couple of months delay by Bulgaria. Overall, relative to January 2007, key policy rates in late 2009 are set lower in Bulgaria, Serbia and Turkey, practically at the same level in Albania and Romania while at a significantly higher levels in Croatia and FYROM.

High key policy rates countries, namely Romania, Serbia and Turkey, have experienced wide fluctuation in their exchange rates. In late 2009, their currencies had depreciated by over 20% compared with January 2007. Croatia and FYROM kept their currencies stable, while the Albanian lek depreciated in December 2008.

Diagram 9: Exchange rates against the euro



Source: National Central Banks.

Loosening reserve requirements constituted another monetary policy response. The central banks of Bosnia and Herzegovina, Bulgaria, Croatia, Montenegro and Romania reduced minimum reserve requirement ratios starting in November 2008.

Table 4: Reserve requirements

Country	Date	Description
Bosnia and Herzegovina	April 2009	Cut reserve requirement ratio for deposits with a maturity greater than or equal to 12 months from 10% to 7%.
Bulgaria	December 2008	Reduced reserve ratio for commercial banks from 12% to 10%.
Croatia	December 2008	Reduced reserve ratio for commercial banks from 17% to 14%.
FYROM	May 2009	Raised the reserve requirement ratio for the banks' liabilities in foreign currency from 10% to 13% and for banks' liabilities in domestic currency from 10% to 20%.
Montenegro	February 2009	Reduced reserve requirements to a flat rate of 11% on all deposits.
Romania	June 2009	Reduced minimum reserve ratios on leu and foreign currency-denominated liabilities of credit institutions with residual maturities of up to two years to 15% and 35% respectively.
Serbia	December 2008	Cut reserve requirements on foreign credit, subordinated credit and financial leasing to 0%.

Source: National Central Banks.

Reserve requirements for foreign currency funds have received special attention and, with the exception of Albania[20], all central banks reduced reserve requirements for foreign currency funds. The motivation behind this action was to enhance liquidity taking into account the significant share of foreign ownership of banks in the region's banking sector and the need to induce support to the subsidiaries by their parent banks. Bosnia and Herzegovina, Romania and Serbia have lowered reserve requirements for foreign currency funds to zero.

Financial sector support

Given the limitations posed by budget deficits, direct measures for supporting the financial sector were not taken by most SEE countries. For financial institutions in SEE countries threats come from rising of non-performing loans due to falling incomes, rising unemployment, the declining real estate prices, currency depreciation and increases in retail interest rates.

[20] The Bank of Albania used an alternative policy response as it increased required reserve usage from 20 percent to 40 percent (with regards to the reserves placed with the Bank of Albania), aiming to enhance banks' flexibility in terms of managing unexpected liquidity needs (BoA 2008).

Table 5: Support to the financial sector

Country	deposit insurance expanded	additional liquidity measures	guarantees, Capital injections
Albania	✓	✓	
Bosnia and Herzegovina	✓	✓	
Bulgaria	✓	✓	
Croatia	✓	✓	
FYROM			
Kosovo			
Montenegro			
Romania	✓	✓	✓
Serbia	✓	✓	✓
Turkey		✓	✓

Source: EBRD (2009).

Liquidity enhancement measures

Responding to the liquidity shortage of the banking sector, central banks of SEE countries took direct liquidity enhancement measures. Specifically, they have undertaken liquidity injections in the form of both open market operations and enhancing banks' recourse to the lending facility.

Table 6: Levels of deposit insurance

Country	Level of household deposit guarantee (expressed in approximate euros)	Date of deposit guarantee announcement
Albania	25,000	March 2009
Bosnia and Herzegovina	10,000	December 2008
Bulgaria	50,000	November 2008
Croatia	55,000	October 2008
FYROM	7,500	Constant since 2000
Montenegro	Full deposit guarantee	October 2008
Romania	50,000	October 2008
Serbia	50,000	October 2008
Turkey	25,000	November 2008

Source: Deposit insurance agencies of SEE countries.

Another measure aimed at safeguarding banks' liquidity was the rise of the level of deposit guarantee so as to avert potential bank runs, which might threaten the stability of financial systems. This action was undertaken in a coordinated manner by most countries during October and November of 2008, following the collapse of Lehman Brothers. Most governments in the region raised the levels of deposit guarantees (mainly for household deposits, see Table 6).

Finally, indirect liquidity support for many banks operating in the region was provided by the special measures adopted by the ECB. Foreign bank presence is significant in the region and the parent banks, which are primarily established in the euro area countries have benefited from the ECB's enhanced credit support measures.

International response

International assistance towards the SEE countries has been crucial for mitigating the impact of the crisis. The balance of payments support packages implemented by the International Monetary Fund (IMF) and EU in a number of SEE countries helped to deflate the partly exaggerated market concern about the fundamental viability of the region's economies and banking sectors. Bosnia, Romania and Serbia benefited from IMF stand-by agreements, while the EU provided €5 billion to Romania as part of a €20 billion IFI package of support.

Moreover, the European Bank for Reconstruction and Development (EBRD), the European Investment Bank (EIB) and the World Bank launched in February 2009 the *Joint International Financial Institutions Action Plan* with the objective of supporting Central and Eastern Europe banking sectors and lending to the real economy. As part of the Joint IFI Action Plan these institutions committed up to €24.5 bn in financial resources to be extended in the region during 2009-2010, mainly in the form of participations in bank equity, SME lending facilities and trade financing.

In parallel to the above mentioned support packages and in order to secure international banks' firm commitment to Central and Eastern Europe countries (including SEE countries), the European Commission, the ECB, the IMF, the EBRD, the EIB and the World Bank launched the *European Bank Coordination Initiative* (also known as the "Vienna Initiative") along with EU countries and the region's central banks, supervisory and fiscal authorities as well as the 15 systemically important EU-based parent banks with subsidiaries in the region.

Overall, the size and firmness of such a wide commitment has helped to mitigate and partly reverse the negative mood towards SEE countries, which has been a crucial step in avoiding a fully fledged regional crisis in late winter 2008/early spring 2009. Given the importance of foreign-owned banks for the region's financial sectors, international co-ordination was pivotal in addressing the reversal of capital flows and in dampening the economic cycle. International commitment helped address potential co-ordination failures and shape a macro-prudential approach to dealing with the crisis' impact in the region as well as improving the efficiency of individual country measures (see also Jens Bastian's contribution in this volume).

Overall assessment

The worst fears of a systemic economic and financial meltdown in SEE countries have receded as global financial conditions improved and economic output started to recover. Improved prospects have mainly been driven by the fiscal and monetary policy stimulus in other countries and the rescue packages led by IFIs and the EU targeting the SEE countries. The domestic policy response has been supportive, but it would have been sufficient to mitigate the impact of the crisis.

Concerns over public finances have now moved to centre stage. The recession is expected to widen public deficits and increase public debt/GDP ratios. Failure to implement medium-term fiscal consolidation could jeopardise growth prospects and increase volatility in money and bond markets. Political instability might be a concern for countries reliant on IMF-led programmes. Failure to comply with programme conditions poses additional risks to macroeconomic stability.

Regarding measures providing support to the financial sector, SEE countries have relied heavily on liquidity provision, mainly through the reduction of minimum reserve requirements. In contrast to many euro area countries, SEE countries have not provided any capital support, but instead have relied on parent groups to enhance the capital base of their subsidiaries in the region. So far, this policy has been effective, since no bank in the region failed.

Near term prospects

The impact of the global financial crisis in the region will be long lasting and it is highly unlikely that SEE economies will return to pre-crisis GDP levels and credit growth rates. Real convergence and deepening of financial intermediation will continue, but at a slower, albeit more sustainable, pace. Key challenges facing the financial sector of the countries in SE Europe in the medium term include:

> *Asset quality deterioration*. The ratio of non-performing loans has been steadily increasing in the course of 2009 throughout the region, with some early sings of stabilisation only in Turkey. If macroeconomic recovery is slower than anticipated, and particularly if coupled with persistence of real estate prices correction, then the quality of the loan portfolio would deteriorate further. The rise in NPLs could be exacerbated by possible adverse exchange rate developments, due to the significant share of foreign currency loans to unhedged borrowers. NPLs are expected to reach their peak in 2010 since they typically lag macro-economic developments.

Diversification of funding sources. With most of SE Europe banks belonging to international banking groups, the banking sector in the region was partly protected from an immediate liquidity squeeze after the Lehman Brothers bankruptcy, since parent banks were acting as lender of last resort for their own subsidiaries, cushioning them from retail deposit withdrawals. More recently, however, as international banks have been forced to deleverage and rebalance their global position, funding has become a key structural constraint through reduced availability and higher cost. As of Q3 2008, banks in the region embarked on a strategy to reinforce their traditional deposit base, giving rise to a "war on deposits". Banks in SE Europe need to rebalance their business, with lending growth linked to deposit growth.

Avoiding a prolonged credit crunch. Low demand for credit as cost of credit rises and heightened concern for credit quality might lead to a prolonged period of low credit growth, even when liquidity concerns have abated. Overall, credit balances have remained flat or even contracted since Q3 2008, while, if exchange rate movements are taken into account, the ongoing moderation of banking activity appears even stronger, with credit balances declining. Deleveraging of households dampens consumption, while corporate deleveraging reduces investment and potential GDP.

In the medium term, banks will face *two structural constraints* in boosting credit growth: a) the relatively slow domestic deposit growth and b) a higher cost of credit risk reflecting higher probability of default (PD) and loss given default (LGD), as well as reduced growth prospects.

Loan diversification and strategic positioning. Loan concentration is high in some of the most affected sectors (e.g. real estate, export-oriented manufacturing and unsecured consumer finance). More generally, banks need to address loan concentration risks and insufficient differentiation across sectors, currencies and geographical entities. This is also linked to the business model that some of the foreign subsidiaries adopted upon entering the region, giving emphasis to credit origination in profitable market segments. A more balanced business strategy may be appropriate in the context of the post-crisis environment encompassing deposit gathering, multiple product offerings and cross-selling.

Adjusting to lower operating margins and profitability opportunities. Heightened funding and credit risk costs imply lower operating margins, while dampened credit growth and economic activity reduces the prospects for commission income (e.g. new loans commissions, trade financing, etc.). These, coupled with increased capital requirements, may lead to significantly lower profitability levels. On the flip side, there remain untapped opportunities for efficiency gains through cost-cutting and optimisation of distribution networks.

An analysis of the outlook of SE Europe financial sectors in order to be complete should also cover the opportunities that lie ahead for those players that manage the downturn effectively, such as:

Deepening integration with EU. The region is heterogeneous in terms of EU integration, but the overall path for a deepening relationship is shared. Romania and Bulgaria joined in January 2007, Croatia, FYROM and Turkey are candidate countries and the other countries of the region are potential candidate countries. For Romania and Bulgaria a significant part of the "EU dividend" has already been consumed in the preceding years. The relatively distinct prospect of EMU membership (closer for Bulgaria which maintains a currency peg with the euro) provides an anchor for economic policies, as well as investors' expectations. Croatia and Turkey have strong economic ties with the EU. For Croatia EU membership will officially re-integrate it to the Central Europe group of countries (Austria, Czech Republic, Hungary, Slovakia and Slovenia), which share many common characteristics. Bosnia and Herzegovina, FYROM, Kosovo, Montenegro and Serbia still have plenty to gain from deepening integration with EU.

The unwinding of asset price excesses and current account imbalances. As exemplified by the Asian crisis, the recession in the Baltics and the extreme case of Iceland, if imbalances in the region were allowed to build up further, then the burst would have been even worse. The global financial crisis has revealed the underlying imbalances in SE Europe countries. Current account deficits have been curtailed, residential real estate prices returned to more sustainable levels and the appetite of economic agents for risk has declined.

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Chapter 4 - Assisting South East Europe through external anchors

Jens Bastian

Introduction

With the economic crisis starting to assert itself in the second half of 2008 in South East Europe, the manner in which governments and central banks initially reacted highlighted a mixture of political un-preparedness, at times outright denial and exposed manifest institutional limitations to act quickly and decisively. If the economic crisis in the region could be reduced to one single phenomenon, and it is arguably delicate to do so, it would be this: the fact that nobody in power saw it coming and hardly anybody knew what to do next. Put otherwise, crisis management and crisis resistance capacity were both in short supply when a twin external shock started to manifest itself in mid-2008 in the region.

From October 2008 onwards the immediate intervention of multi-lateral financial institutions became the means of last - and only – resort for governments and central bank authorities in Serbia, Bosnia & Herzegovina, Hungary, Romania, Ukraine, Belarus etc. At that stage of external intervention the fast emerging solvency crises lacked domestic policy solutions in Belgrade, Sarajevo, Budapest, Bucharest and Kiev.

Instead of risking going broke, many countries had to 'go cap in hand' to international financial institutions (IFIs); first to Washington (IMF and World Bank), and subsequently to London (EBRD, *European Bank for Reconstruction and Development*) and Brussels (EU, i.e. EIB, *European Investment Bank*). Only through the availability of such a multiplicity of external [financial] anchors did these countries avoid the modern-day equivalent of financial meltdown, namely having to throw in the 'default towel'.

External anchors such as the IMF, World Bank, EBRD, EU and EIB thus have a critical role to play. The year 2009 has been one of the busiest for such institutions. Through their lending programs they are re-defining a responsibility that consists in sheltering countries in dire need and assisting them in the objective to consolidate their gains after 20 years of complex economic, financial sector and political transition.

These anchor institutions can provide the significant financial resources and administrative skills. They equally draw on a wealth of experience and lessons learnt when providing emergency assistance in the past to the region. As shall be illustrated, such external anchors have proved to be rather flexible in the adoption and implementation of coordinated rescue programs based on a division of labor, resources and mandate. In a word, a new sense of purpose for such external anchors is emerging.

The consequences of the economic crises across South East Europe will nevertheless be felt for many years to come. Painful cuts and delicate trade offs are in prospect as a result of the economic recession affecting the region. After a decade of GDP growth, countries must now prepare for a new era of austerity. Ultimately, this process will also spark debate about the timing and reasoning for scaling back crisis assistance programs from such external financial anchors.

The macro-economic situation

Since the onset of the financial crisis in the fall of 2008 the global economic environment continued to worsen into the first half of 2009 while slightly easing towards the end of 2009 (EBRD 2010a). South East Europe is among the regions most adversely affected, reflecting dramatic GDP contraction (see Sanfey contribution in chapter 1), sizeable fiscal deficits and numerous external challenges, e.g. current account shortfalls, liquidity problems in foreign currency inflows and declining export capacity (IMF 2009a).

The economic and financial crises caught up with the economies of SEE in the fourth quarter of 2008. All countries in the region registered a sharp output decline in 2009, with the Romanian, Serbian and Bulgarian economies particularly adversely affected (IMF 2009a). Such a combined freefall in the economies of the Balkans is only comparable to the initial transition period in the early 1990s. The depth of the economic meltdown in the region is reminiscent with the onset of economic transformation two decades ago. The economic and financial sector crises constitute the most significant external shock since the beginning of transition two decades ago (Bastian 1998).

More specifically, the crises affecting the region since mid-2008 risks setting many of them back to levels of GDP decline witnessed individually one decade ago and as a group of countries in the Western and Eastern Balkans two decades past. In other words, what is at risk are economic gains and social advancements, privatisation benefits and fiscal improvements that these countries' economies and societies sought to consolidate during the past decade (Mitra et al. 2010).

External anchors to the rescue

Against this economic background governments and central banks have had to decide how to modify their policies and adjust their toolbox. The IMF observed in April 2009 "it is important to realize that the global conditions conducive for the previous high growth rates belong to the past" (IMF 2009a, p. 7).

Table 1: Crisis Lending to Countries in Central, Eastern, South East Europe

Country	Timing	Volume (USD)	IFIs
Hungary	October 2008	25.4 billion	IMF, WB, EU
Ukraine	November 2008	16.4 billion	IMF
Latvia	December 2008	10.5 billion	IMF + EU
Belarus	January 2009	2.46 billion	IMF
Serbia	January 2009 March 2009 October 2009	530 million 4.0 billion 1.4 billion	IMF IMF Russian Finance Min.
Poland	April 2009	20.5 billion	IMF (Flexible Credit Line)
Bosnia & Herzegovina	May 2009	1.3 billion	IMF (Stand-by Loan)
Romania	March 2009	27 billion	IMF, WB, EU, EBRD
Total External Funding		110,4 billion	

Source: IMF 2009c: http://www.imf.org/external/np/exr/facts/crislend.htm and compellation by the author.

International funding institutions such as the IMF, World Bank, EBRD and EU came to the rescue of eight countries in central, Eastern and South East Europe. Between October 2008 and May 2009 they provided approximately USD 110 billion of emergency lending to Romania, Serbia, Ukraine, Belarus, Hungary, Poland, Bosnia & Herzegovina and Latvia to weather the consequences of the economic and financial crises (see Table 1). Other countries such as Albania, Bulgaria, Croatia, Montenegro and the FYR Macedonia are currently considering their options (WIIW 2010).

It is important to understand that the financial assistance programs provided by different IFIs and the EU include noteworthy distinctions as regards mode of intervention, volume of assistance and level of conditionalities attached. More specifically, the IMF mainly provides liquidity assistance to individual countries, while the World Bank, the EBRD and EU institutions can forward capital financing and budgetary support (Bastian 2010a).

Notwithstanding these differences in approach and substance, the combination and coordination of these interventions sent a highly symbolic message to international capital markets during the past year; namely that East, central and South East Europe ultimately have a financial safety net that will be extended across these regions!

In three of the eight cases, namely Hungary, Latvia and Romania, the rescue packages have been worked out in close cooperation between multiple international institutions. The IMF, the EU, the World Bank, the EBRD and other multilaterals are providing to these EU members a variety of financial assistance arrangements with different levels of conditionalities attached (ibid. 2010a).

The Romanian case:

The single largest rescue program concerns Romania. The Finance Ministry and the Central Bank in Bucharest completed talks with the European Commission, the IMF and other IFIs to seek "medium-term foreign financial assistance" in March 2009. The rescue package totals USD 27 billion under a two-year stand-by arrangement. The financial details include a loan of USD 17.5 billion from the IMF. Another USD 9.7 billion of emergency funding is provided by the EU, the World Bank and the EBRD (IMF agreement with Romania 2009).

Bucharest's need for external funding stems from its short-term foreign debt repayment obligations in the course of 2009 and the effects of the sharp drop in private capital inflows, in particular in foreign direct investment. The IMF-led rescue program aims to maintain adequate capitalisation of commercial banks and provides liquidity facilities for domestic financial markets. The package also contains specific provisions to increase allocations for social programs, particularly regarding spending initiatives for vulnerable pensioners and public sector employees (ibid. 2009).

The IMF forecast during the negotiations with the government that the Romanian economy was expected to shrink by as much as 4.1 percent in 2009, while the current account deficit would reach 7.5 percent of GDP (ibid. 2009). Six months later in August 2009 while undertaking the first review of Romania's performance under the USD 27 billion agreement, the IMF doubled its forecast for economic contraction in 2009 to as much as 8.5 percent (IMF interim review 2009). Romania's economy shrank by 7.1 percent in 2009.

In fact, Romania successfully re-negotiated the terms of reference of its lending program. More specifically, it received permission from the IMF and the EU to run higher budget deficits in 2009 and 2010 (ibid. 2009). The revised objectives include an agreed fiscal deficit of 6.8 percent of GDP for 2010 (FT June 2010).

But even these revised forecasts and adjustments were not enough. In November 2009 the IMF delayed the release of the third financial tranche (€1.5 billion) to Romania while the country continued to struggle to establish a new government, which would comply with agreed policy targets. The disbursement was only released in July 2010 after the government of Prime Minister Emil Boc agreed to spending cuts in public sector wages (minus 25 percent) and an increase of VAT from 19 to 24 percent. (FAZ 2010c).

The Serbian case:

In the case of Serbia, the authorities in Belgrade had to go cap in hand to Washington twice within three months! After a first emergency loan was approved by the IMF in January 2009, Serbia reached a second agreement for a 27-month, €3 billion loan to help its economy address the effects of the global financial crisis in late March 2009. The IMF loans will be used to replenish the central bank's foreign currency reserves, a move meant to stabilize the domestic currency, the dinar (Eddy 2010).

Finally, and for the third time, the Serbian authorities required external financial assistance in October 2009 when they secured a USD 1.4 billion loan from the Russian Ministry of Finance. Serbia is the only country that repeatedly required external financial resources during 2009. Is funding inflow also has the greatest variety of sources from international institutions (Ricard 2009).

Labor unions and citizens' organisations resented taking on the burden of the IMF's two-year standby credit arrangement with Belgrade while large private sector businesses sought additional government subsidies. The revised 2009 budget cut public spending by USD 1.3 billion. Public sector employees' wages were reduced between 10-15 percent.

Employment levels in state administration were downsized by 10 percent until mid-2010. In practice this included redundancies and involuntary early retirement for 8.500 public employees (New Europe 2009a). In order for the IMF to release the third credit tranche the Serbian government also had to comply with the submission of pension reform legislation in June 2010 (FAZ 2010b).

Can Albania and Bulgaria be considered outliers?

As one country after another sought multilateral funding from a combination of IFIs, the growing list also exposed those countries that have yet to come forward, and are holding their cards close to their chest.

One such country is Albania. The central bank governor Ardian Fullani urged the government to turn to the IMF for loan assistance in April 2009. Fullani cited a lack of liquidity in foreign currency inflows as the main reason for recommending approaching the IMF (IHT 2010a). The decision not to seek assistance from the IMF was ultimately taken after the establishment of a new coalition government following the general elections from June 28th 2009.

However, to date the Albanian government has yet to restore full relations with the IMF. Albania is also an outlier in two other respects. For one, it was the last country in the region to receive a credit rating from any of the three leading international credit rating agencies. In June 2007 Moody's Investors Service ranked the country on a par with Ukraine, Indonesia and Jamaica. The

B1 rating was four steps below the investment-grade level of Baa3 assigned to Balkan neighbors Croatia and Bulgaria at the time.

Secondly, Albania only made a successful Eurobond debut on international capital markets in November 2010. Albania debuted its first five year, 300m Eurobond with a five year maturity at a maximum interest 7.5 % rate. Since a decade Albania had been trying unsuccessfully to finance its budget deficit with the issuance of Eurobonds. In 2009 the finance ministry had to cancel Eurobond plans because prices and interest rates in the bond markets were deemed too high. Instead the government took out a €193 million syndicated loan from 20 commercial banks that was managed by *Deutsche Bank* and Greece's *Alpha Bank* (ibid. 2010).

A second example is the EU member Bulgaria. In the case of Sofia, political and electoral considerations also played a role in *not* approaching the IMF before the outcome of the July 5th 2009 general elections. The political sensitivity of the issue during the election campaign prevented the authorities from seeking a financial agreement with the IMF.

How much an agreement with the IMF became a political football during the campaign was exemplified by the then leading opposition politician, the Sofia mayor Mr. Boiko Borissov's party GERB, which argued in favour of a pre-cautionary agreement with the IMF as part of its economic policy priorities. Mr. Borissov subsequently won the elections and went on to become prime minister of Bulgaria. But his government has not sought the financial assistance of either the IMF and/or the EU.

The amount Bulgaria would need was estimated to range between one half and two-thirds of USD 25 billion, the volumes secured from the IMF and the EU by Hungary and Romania in 2009 (Bastian 2009). While the Bulgarian economy grew by six percent in 2008, a year later GDP contraction reached 5.1 percent. Such a level of macro-economic adjustment is remarkable within one year.

Bulgaria's fiscal position is a key reason why the country's authorities have to date successfully navigated around IMF loan assistance. Bulgaria registered a budget surplus between 2006-2008 and had the lowest budget deficit in the EU in 2009. However, its economic and financial vulnerability is defined by risks from the private sector, which has high levels of external debt. In 2009 Bulgaria had gross external debt of €37.6 billion, equivalent to 111 percent of annual GDP (Kathimerini 2010).

Moreover, Bulgaria's foreign direct investment (FDI), which constituted a key driver of GDP performance in recent years, is declining since end-2008. FDI plunged to minus €21.9 million during the first quarter of 2010, from a positive €926 million in January-March 2009 (IHT 2010c). Declining foreign investment on such a scale signals diminishing prospects for economic recovery among the EU's poorest emerging economy and may yet trigger the need for international financial assistance the country's authorities have so far sought to avoid.

Equally, neither have Croatia, FYR Macedonia and Montenegro negotiated financial assistance from the IMF, the World Bank or the EU. This does not imply that they did not consider it or that governing and central bank authorities always see eye-to-eye on the subject matter. Nor does it suggest that any of these countries are on safer economic and financial grounds today and therefore not in need of such options. However, the apparent difference between those that sought international financial assistance and the cluster of countries in the region that have – so far – successfully held out is all the more striking.

Is the crisis assistance discretionary, tilted towards EU members?

When considering funding assistance from the international community towards recipient countries a major difference has to be borne in mind. Hungary, Poland and Romania are EU members, with other levels of institutional integration than Serbia, FYR Macedonia, Bosnia & Herzegovina, Montenegro or Albania.

This difference highlights a major drawback for non-EU members in the Western Balkans. Their only route available for possible bailout operations are presently IFIs, while the EU's hand for immediate financial intervention through its lending institution – the EIB – is limited for non-members. Put otherwise, emergency lending arrangements to Balkan countries may raise the very concerns they are intended to calm: that the crisis threatens to split the region into rival camps.

The EU cannot assist non-EU member countries in the Balkans in the same manner as it did in the case of neighboring Hungary, Romania and possibly Bulgaria. The EU balance of payment support facility is only available for EU members. Equally, the Commission's budgetary resources are selective and discretionary; favoring the new EU members from Central and Eastern Europe.

In order to counter-balance this structural discrepancy, and divert the criticism that the EU may appear biased, the Commission has sought alternative financial instruments. In the course of 2009 the EU has started to frontload specific funds for countries in the Western Balkans. The EU is using one of its core instruments - namely *IPA* - to deliver funding assistance to non-EU members in the region.

IPA stands for *Instrument for pre-Accession* assistance. It offers financial assistance to countries aspiring to join the European Union for the period 2007-2013 (see Table 2: EU Support for Non-EU Members in the Western Balkans and Turkey 2009/102). The **beneficiary countries** are the former Yugoslav Republic of Macedonia, Croatia, Turkey, Albania, Bosnia and Herzegovina, Montenegro, Serbia and Kosovo.

Table 2: EU Support for Non-EU Members in the Western Balkans and Turkey 2009/10

	Volume	Focus	Timing
Bosnia & Herzegovina	€ 39 million	Grant Funding	August 2009
Serbia	€ 100 million € 100 million	Budgetary Support Credit Lines 2010	July 2009
Western Balkans & Turkey	€ 85 million	Grant Finance	July 2009
EIB Lending Facilities (Western Balkans)	€ 3.2 billion	Loan Finance	2009/10
Western Balkans Investment Framework	€ 130 million	Pooling grants + loans from EU/EIB/EBRD/CEB	2009/10

Source: European Commission 2009c.

IPA resources earmarked for capacity building projects are being re-directed as direct budgetary support means. 85 million will be given to Western Balkan countries and Turkey to help secure investment in their economies, reform their banking sectors and improve competitiveness. Serbia received €100 million from IPA funds of the European Commission for "general budget support" in July 2009 (IPA 2009). The Commission noted that such support seeks to "help with the stabilisation of the country and ease the economic and social consequences of the crisis" (ibid. 2009, page 13).

This form of EU financial assistance to non-members applies for the first time Art. 15 of the IPA regulations. This clause foresees that in extraordinary circumstances earmarked resources from IPA can be re-directed towards direct budgetary support of an EU candidate or accession country or SAP country (*Stabilisation and Association Agreement*).

In terms of volume and macro-economic impact these different measures by the EU and/or in cooperation with other IFIs seek to reiterate the Commission's commitment to the region. They underline that the EU recognizes the institutional discrepancy between EU members and non-members (accession countries, candidate countries and potential candidate countries) as regards funding availability during the global crisis. The Commission is thus prepared to support countries in the Western Balkans by existing means and new instruments from its vast [financial] toolbox (Bank of Greece 2009).

To further underline this approach, the EU also provided a credit line to Serbia in 2010 in two tranches of €100 million each. Equally, the EU approved a €39 million financial crisis response package for Bosnia and Herzegovina in August 2009. The €39 million grant finance will support the development of small and medium sized enterprises and provide significant investment in infrastructure in the transport, environment, and energy sectors (Szewczyk 2010).

Funding will also be granted to the *Deposit Insurance Agency* in order to enable it to prevent deposit outflows due to the financial crisis. The €39 million were allocated under the IPA envelope for Bosnia and Herzegovina. A second program for the country to ensure continuation of institution-building efforts was adopted by the European Commission in autumn 2009 (Castle 2009).

The *Western Balkans Investment Framework* (WBIF), which was established in December 2009, is a case in point. The Framework is a joint initiative by the Commission, EIB, EBRD and CEB which seeks to pool grants, loans and technical expertise together to prepare financing for a common pipeline of priority investment projects in the Western Balkans. The WBIF will pool grants from the Commission's budget, IFIs and bilateral donors in two programmes: (i) joint lending facilities, and (ii) joint grant facilities. As of December 2009 the WBIF included grants totalling €130 million, with follow-up lending facilities expected to match this level from the outset of establishing the investment framework (European Commission 2009c).

Is all this enough? Surely not, and it pales in significance when compared to the funding muscle applied by the IMF, World Bank and EBRD. But the comparison of volumes may in fact be misleading. Rather, we can observe that a division of labor is currently taking place. IFIs are providing large amounts of emergency lending to the Western Balkans, with flexible conditionality attached to the rescue programs. By contrast, the EU Commission is supplementing these interventions with limited, but targeted resources allocations, while being pro-active as regards the adoption of and adherence to conditionalities for recipient countries.

But this line of argument about EU initiatives or the lack thereof also has a flip side. In many less direct and visible ways the EU, individual EU countries and the *European Central Bank* (ECB) have assisted non-EU members in the Western Balkans and Turkey on a far larger scale.[21]

For one, the ECB extended its liquidity facility to Hungary's and Poland's central banks directly. More specifically, the ECB established temporary reciprocal currency arrangements to support dollar and/or euro liquidity. In autumn 2008 the ECB agreed with the central banks of Hungary and Poland to support liquidity operations in these countries. However, their gain was the neighboring countries' pain. More specifically, those who are not (yet) members of the EU, "only" have a stabilisation and association agreement (SAA) with Brussels and thus have a more limited set of financial support available to them.

Furthermore, at the G-20 Summit in London in April 2009 EU member

[21] I am thankful to Mr. Panayotis Gavras from the Black Sea Trade and Development Bank in Thessaloniki, Greece for useful arguments on this subject matter.

countries pledged an additional €100 billion to the IMF, knowing full well that much of these resources would also end up in Central, East and South East European countries' stand-by arrangements with IFIs (G-20 Final Communiqué, 2009).

The ECB has also pumped phenomenal amounts of liquidity into the Eurozone financial systems, and those Eurozone based commercial banks with local subsidiaries and branches in South East Europe have taken advantage of this window of opportunity and thereby provided liquidity support to their regional holdings. The sums involved were not inconsequential for the continuation of banking operations at a time when money and credit markets had essentially dried up in late 2008, early 2009.

It could thus also be argued that the Commission, the ECB, and individual EU countries have indirectly been bailing out central, Eastern and South East European financial sectors in a fashion similar to the more direct measures they are taking within the EU and the single currency zone.

Euro zone based commercial banks are huge beneficiaries of funding arrangements such as the ECB's liquidity access programs. Look no further than Greece, where the commercial banks with significant holdings and investments in the Balkans and beyond have obviously (and fortunately) been able to re-finance their operations by taking advantage of accessing various ECB liquidity facilities.

Initiatives to support financial sector stability in South East Europe

Economies in the region are being adversely affected by a financial sector that has relied far too long on foreign currency lending being provided by Western parent banks to their local subsidiaries. Any forecast for the timing and scope of economic recovery in South East Europe structurally depends on the region's financial sectors to resume lending to households and the corporate sector.

Since the beginning of the global financial crisis in mid-2008, small and midsize companies have faced a serious credit crunch in all countries of the region (IMF 2009b). This credit crunch is being implemented by commercial banks majority-owned by foreign parent banks. Kaoudis et al. (Chapter 3) highlight to what degree foreign financial institutions have penetrated banking sectors in the region. With the exception of the EU member Slovenia, every other country in the region posts at least a foreign ownership ration of 60 percent and more.

As Kaoudis et al have argued, Greek and Austrian commercial banks are most heavily exposed to countries in central, Eastern and South Eastern Europe. They had the highest share of lending as a percentage of annual GDP of all EU countries in 2008, namely a staggering 76.7 percent and 49.3 percent, respectively (Kerdos 2010).

These numbers would even be higher if the data also included Serbia, Albania and FYR Macedonia, three additional countries where Greek commercial banks implemented a pro-active lending strategy during the past decade. The countries include Poland, Russia, Czech Republic, Turkey, Hungary, Romania, Croatia, Slovakia, Ukraine, Bulgaria, Estonia, Latvia and Lithuania.

Put otherwise, while many competitors initially hesitated, Greek and Austrian commercial banks had the risk appetite to invest early and pro-actively in the region. Geographical proximity mattered for Greece in South East Europe and for Austria in central Europe. Both countries' banking sector investments expanded their theatre of operation beyond the initial regional confines.

Such high loan exposure combined with exorbitant loan growth among private households and an over-leveraged corporate sector suggests that various parent banks from Western Europe created their own sub prime markets in Serbia, Montenegro, Hungary, Albania, Ukraine, Romania and Bulgaria between 2000 and mid-2008. Money from Western parent banks fueled a debt-laden binge in South East Europe that blinded investors to the risks of cross-border, foreign currency lending (Bastian 2010b).

The key characteristic of this sub prime market and central driver was foreign currency lending, mostly denominated in Swiss franc and/or euros. Households and corporations alike bet against their own domestic currency and central banks' monetary policy. They found willing subsidiaries of foreign commercial banks that were eager to quickly increase market share vis-à-vis their competitors (Ewing 2010a).

There are further underlying issues that need to be addressed short-term. The credit crunch that is currently affecting countries in South East Europe follows a decade of excessive loan growth of about 50 percent a year, in particular in mortgage lending denominated in foreign currencies. Between 2004 and mid-2008 the emerging housing bubble in parts of South East Europe was impossible to overlook. Real estate prices doubled within this four-year period in cities such as Podgorica, Belgrade, Tirana and Pristina (Ewing 2010b).

This gold rush mentality came to an abrupt halt in mid-2008. As evidenced by the so-called *Real Vienna* in May 2009, the most important annual trade fair for corporate property investment in central, Eastern and South East Europe, investment flows into corporate property development only reached €220 million in the three regions during the first quarter of 2009. This level constitutes a decline by two-thirds compared to the fourth quarter in 2008 (FAZ 2009a).

Cooperation between multi-lateral lenders and commercial banks

Extending loan guarantees to the real economy and pledging continued support from Western parent banks to their local subsidiaries in South

East Europe in times of sustained economic meltdown are gradually seeing the light of day. A number of recent policy initiatives highlight the need to identify commercial alternatives to scarce external funding. The focus of these initiatives is to reassure the banks' customer basis and establish coordinated rescue operations with multi-lateral financial institutions.

One such initiative concerns the provision of capital support to commercial banks operating in the region through multi-lateral lenders. As Table 3: EBRD Capital Support to UniCredit in Central, Eastern, South East Europe 20093 illustrates, in 2009 the EBRD extended lending totaling USD 578 million into the central, Eastern and South East European subsidiaries of the Italian bank *UniCredit (UC)*. The May 2009 agreement to provide capital support to UniCredit is the largest in volume to date.

Table 3: EBRD Capital Support to UniCredit in Central, Eastern, South East Europe 2009

UniCredit (UC) Subsidiary	Lending Facility	Total Volume (million €)
UC Bank (Hungary)	SME Lending	€ 50 million
Bulbank (Bulgaria)	SME Lending	€ 50 million
Zagrebacka Banka (Croatia)	SME Lending	€ 50 million
UC Bank (Serbia)	SME Lending	€ 30 million
UC Leasing (Serbia)	Leasing	€ 15 million
UC Bank (Bosnia, Mostar)	SME Lending	€ 30 million
UC Leasing (Bosnia, Sarajevo)	Leasing	€ 15 million
UC Leasing (Ukraine)	Leasing	$ 25 million
Ukrsotsbank (Ukraine)	Tier 2 Capital	$ 100 million
ATF (Kazakhstan)	SME Lending	$ 70 million
ATF (Kazakhstan)	Energy Efficiency	$ 30 million
ATFBank (Kyrgyzstan)	SME Lending	$ 20 million
		€ 433 – 517 million*

Source: EBRD/UniCredit 2009. * According to USD/Euro currency fluctuation.

UC is the single largest financial investor and the biggest banking group (by assets) in the three regions (Unicredito 2010). UniCredit has a network of over 4,000 branches in 19 countries of central, Eastern and South East Europe. Since the mid-1990s UniCredit has invested €10 billion of equity in the three regions and has €85 billion of total customer loans in the regions.

The EBRD is providing loan finance to UniCredit's subsidiaries. These loans are not intended to clean up banks' balance sheets in the eight recipient countries. Rather, they are earmarked to support local branches in extending loans to small and medium-sized companies, enable leasing finance and assist energy efficiency projects. The lion's share of the USD 578 million went to UniCredit's subsidiaries in Ukraine and Kazakhstan (EBRD/UniCredit 2009).

This joint venture illustrates how the EBRD has found a renewed sense of purpose in stabilizing the financial sectors in transition economies. The EBRD also extended similar loan arrangements to *Banca Comerciala Romana* (BCR), a Romanian subsidiary of the Austrian bank *Erste Bank* in 2009. The

London-based bank is quickly becoming the second-most important lending institution next to the IMF in South East Europe. Since the beginning of 2009 the London-based bank increased its investments in the financial sector among 30 member countries by 50 percent, to €3 billion (EBRD 2010a).

The EBRD's investment is part of a wider crisis response strategy that seeks to implement joint initiatives with the World Bank Group and the EIB. The latter announced in May 2009 that it had launched a two-year loan program worth €1.4 billion to assist Serbia with external funding for small and medium-sized enterprises and priority infrastructure projects (EIB 2010). The EIB's loan facility is earmarked for small and medium-sized enterprises and priority infrastructure projects in Serbia. Together, the three IFIs have pledged over €24 billion in support of the banking sectors in Central, Eastern and South East Europe, thereby providing lending alternatives to businesses hit by the global financial crisis (EBRD 2010a).

The picture that is gradually emerging in central, Eastern and South East Europe is thus one of delivering comprehensive - and increasingly coordinated - responses to the financing requirements of individual banking groups. These IFI-led responses seek to either stimulate and/or complement joint funding options of Western commercial banks operating in the three regions. These interventions by external anchor institutions underscore a division of labor between IFIs and illustrate in practice a high degree of operational flexibility and program adaptability towards recipient countries.

Exit strategies of external anchors

Governments and civil society face a major task ahead to identify what lessons can be learned, and must be applied, from the economic calamity 20 years after the events of 1989/90. This task will have to include re-tooling existing policy responses. As the developments since mid-2008 have shown in the region, crisis management and policy solutions lagged behind the unfolding dynamics of economic events. Equally, the nature of the responses that have since been formulated with the coordinated assistance of the international community may lead various actors involved to re-appreciate - and revisit - the notion of *political economy*.

The EU Commission in cooperation with numerous IFIs has mobilized unprecedented levels of emergency lending programs and grant facilities in order to confront the short-term needs of the region. But the Commission, IMF, EBRD, World Bank, EIB and CEB are also recognizing that more needs to be done apart from the provision of financial resources. Issues deserving attention in Belgrade, Bucharest, Tirana, Sarajevo and Skopje concern:

1. On what growth model should future economic development be based? GDP performance resulting from

credit booms, excessive household and corporate debt as well as over-reliance on foreign capital inflows and unsustainable current account deficits has been called into question.

2. The downside of fast-track financial integration has become visible. What lessons have to be drawn for financial sector reform and oversight, risk management procedures, reducing foreign currency lending?

3. The transition agenda must revisit the role of the state, its institutional quality and crisis reaction capacity. Redefine instead of minimize the role of the state, its regulatory scope and fiscal policy making competence. This endeavor includes re-thinking how governments in the region can generate fiscal space *without* having to rely so heavily on IFIs?

4. External anchors coming to the rescue of countries severely hit by the economic downturn in the region cannot extend these levels of lending much longer. At some stage they will have to start moving towards dismantling some supportive policies (IMF 2010). This implies engaging in winding down exercises and identifying gradual exit strategies from these programs, not least in order to avoid creating a culture of dependency.

Handling issues such as figuring out exit strategies and/or capital increases is delicate. Discussing such strategies now may spook markets and policy makers that measures could be withdrawn too quickly and thus undermine the recovery. The same holds vice versa. Being silent about winding down runs the risk of encouraging authorities in the region to become complacent, thinking IFIs will stick with lending programs and grant facilities too long. How fast IFIs will unwind the extraordinary support measures put in place since 2008 will critically depend on developments in a still fragile economic environment in the region.

The process of unwinding has no time limitation. But the funding basis of some IFIs has capital limits. The EIB is already operating at the limits of its funding and lending capacities. It has extended in excess of €6 billion to countries in the Black Sea region (including Bulgaria, Romania, Ukraine and Turkey) and approximately €2.2 billion for the Western Balkans, mostly as credit lines for infrastructure projects and SME lending in 2008-10 (New Europe 2009b).

The EBRD appealed to members for an extra €10 billion to lift its capital by 50 percent. The request, which was approved at the EBRD's annual shareholders' meeting in Zagreb, Croatia in May 2010, enables the EBRD to expand its lending and compensate for the sharp decline in private capital flows into emerging European markets (EBRD 2010b). The need for a capital increase also underscores concerns that the region's economic and financial sector difficulties are far from being overcome.

If the EBRD would have continued to operate with its current capital, the Bank would have had to limit its annual lending in 2009-10 and reduce it thereafter. The €10 billion capital increase allows the EBRD to commit €20 billion in extra funding in 2010-15. By mobilizing extra capital from private investors, the total additional funds raised could reach €60 billion (Parkinson 2009).

Such an unprecedented capital increase by the EBRD underlines how precarious any economic recovery in the region is viewed by lending authorities in London and beyond. In February 2010 the World Bank sought a capital increase from its shareholders. The World Bank argued that without the capital increase it would need to restrict lending by the middle of 2010 after the worst recession in six decades pushed countries' loan requests to a record high (IHT 2010b).

The depth of the global recession and the additional funding needs expressed by IFIs such as the EBRD and the World Bank illustrates to what degree the downturn is transforming such institutions. Before the crisis struck the EBRD's countries' of operation, the US, the biggest shareholder, was keen to reduce the bank's activities on the grounds that its funding role in supporting post-communist transition was nearing the end as market economies were taking root.

But the economic crisis has reduced the amount of private capital available across the region. The EBRD, along with other IFIs, increased its own resources thereby extending the development bank's *raison d' être*. The EBRD's job is far from 'mission accomplished' from the Baltic Sea to the Black Sea.

It may not only be a matter of identifying new funding resources or detailing winding down options, but rather to re-allocate existing resources from lending to capacity building. More specifically, such a shift includes the concentration of resources on the provision of technical expertise in key policy areas whose vulnerabilities have been exposed by the deep recession. The non-financial input that IFIs can provide primarily concerns the macro-economic and structural diagnosis capacity of policy makers, e.g. in finance ministries and central banks.

The focus of the EIB is a case in point. Over and above considerably extending its lending resources to countries in the region, it is focusing on making additional financial engineering advice available. This includes technical advice on absorption capacity of available funds for EU members

Bulgaria and Romania.

This expertise is all the more pertinent because it includes programs on how to use these resources before risking losing them for lack of transparency or administrative absorption capacity. The heart of the matter here is the faculty of external actors to help anchor fiscal and structural policy making capacity that can contribute to greater buffers and deeper crisis adjustment aptitude.

The role of external anchors is also important in one other key arena of policy making. Through its arsenal of lending programs and provision of technical expertise they engage the countries of the region in a sustained effort of institutional cooperation and policy coordination. This engagement can contribute to avoid potential alternative avenues of crisis management and risk mitigation in the region. Two such avenues concern:

> individual countries seeking immunity from economic and financial sector vulnerability,
>
> adopting Asian style self-insurance strategies.

The available toolbox for the execution of such strategies includes trade protectionism, competitive currency devaluation, accumulation of foreign currency reserves, considerably increasing capital requirements (in foreign currency) for Western parent banks operating in the region and seeking to monopolize the allocation of financial resources. Countries in the region are considering risk mitigation strategies, and it is in the interest of IFIs and the EU to support them in refraining from adopting counter productive measures.

At the end of the day, this engagement is going to be energized by and shaped through the vehicle of deepening the countries' EU accession dialogue. The magnet of EU integration adds to this strategy of engagement and provides the additional political momentum to carry on with reform efforts in the region.

Two recent developments underscore the importance of re-vitalizing the EU magnet for the Western Balkans. For one, the EU visa liberalisation regime, which came into force for citizens from Serbia, Montenegro and FYR Macedonia in December 2009 provided tangible and lasting benefits for citizens across these three countries (European Commission 2009b). Albania and Bosnia and Herzegovina were included in November 2010, leaving only Kosovo outside.

The other key development concerns the EU Commission's decision to unblock the so-called Interim Agreement with Serbia. This unblocking opened the door for the implementation of the Interim Agreement by all EU members and paved the way for Belgrade to submit its formal membership application in December 2009 before the Swedish EU presidency came to a close (Ricard 2009).

The EU's continued power of attraction is also mirrored by Albania's and Montenegro's membership applications in April 2009 and December 2008, respectively. Even Iceland's EU application in September 2009 adds a new dimension to the enlargement agenda in the coming years (Reljic 2010).

Conclusion

The region of South East Europe now finds itself in the early and volatile stages of what could be an economic recovery. The rate of economic contraction in the region is slowing down. Technically, most countries are moving out of recession in 2010. According to the EBRD's GDP forecast in 2010, Bosnia & Herzegovina, Romania and Montenegro are expected to continue registering economic contraction (EBRD 2010). First-quarter 2010 economic growth in Serbia reached 0.5 percent (FAZ 2010b).

At this stage it is speculation if the nature of any recovery will be L, W, U or V shaped in the region's economies. The coming months are still going to feel very much like a recession to many constituencies across South Eastern Europe. In the next years the trend growth rate of most countries in the region will be closer to 2-4 percent than in the vicinity of 5-8 percent as during the past five years.

Key components of South East Europe's economies, such as the unemployment rate, household consumption, residential investment, non-residential construction, capital spending and export capacity remain volatile and trail macro-economic indicators like GDP development by several months. The value of non-performing loans will continue to increase into 2010. In a word, the economic and financial sector crises could still turn out to be self-reinforcing.

In addition, concerns about the medium-term solvency of governments will soon appear on the radar. In light of their heavy borrowing from IFIs in 2008/09 and possibly beyond, countries such as Romania, Serbia and Bosnia & Herzegovina will face re-payment obligations that severely restrict their fiscal policy making options in the coming years.

The broader concerns across the region are political. How will different constituencies react to economically difficult times and a perception that their hard-earned gains risk being erased? Voters, forced by recession to live more leanly, are irate. Ample opportunities to use elections as a tool for political punishment have already been taken advantage of and will continue to present themselves on the political calendar (Judah 2010).

Two decades after the collapse of the Eastern block, the countries of Eastern and South East Europe are facing an uncertain future and the legacies of the recent past. The societies in this region are well schooled and practically experienced in the meaning of imploding states and failed economic systems. They have successfully sought answers to what went wrong before the historical events of 1989/90 (Bechev and Nicolaidis 2010).

What growth model will they decide to apply while adjusting to the necessary winding-down, scaling back exercise of relying on IFI emergency funding? Starting in 2010 the pro-active lending by external anchor institutions is giving way to a slow unwinding of obligations. Identifying the exit options and repayment requirements will be politically contentious and limit spending alternatives in other budgetary sectors.

In light of what has happened, the trajectory ahead for the countries in South East Europe lacks a clearly marked road map. But what is becoming more obvious by the day is the following: the current import-led, financial sector driven and debt-fuelled transition trajectory of economic development in the region is subject to root and branch re-evaluation.

A broader re-examination by public authorities of the government's role in the economy will have to take place across South East Europe. This may include exploring new ways to expand the government's responsibilities. This necessary introspection should not be inward looking and has to avoid protectionist policy solutions. The issues that deserve special placement on the agenda concern:

(i) the identification and creation of additional fiscal space,

(ii) their crisis management / reaction capacity and regulatory expertise,

(iii) financial sector regulation, in particular foreign currency lending.

More broadly speaking, one of the key lessons learned during the crisis concerns where – and how - the boundary between government and the market should be (re)drawn. The tenets of free-market reform are now under scrutiny. The necessary debate about the demarcation lines has just begun.

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Epilogue - Impact of the Greek crisis on its neighbours in South East Europe

Jens Bastian

As the twin fiscal and public debt crises unfold in Greece, neighbouring countries in South Eastern Europe are anxiously trying to determine how they will be affected by the developments in Athens. In light of Greece's track record of foreign direct investment, its foreign policy focus on the region and growing trade volumes between the countries neighbouring Serbia, Albania, FYR Macedonia, Romania, Bulgaria and Turkey cannot remain indifferent to the magnitude of the crisis next door. Nor can they cast a blind eye to the possible solutions being addressed in Athens or advocated in Brussels, Berlin and Washington.

Both Serbia and the EU member Romania currently have IMF-led stand-by agreements. These facilities have been in place since early 2009. In the case of Romania the IMF program is being supplemented by financial assistance from the European Union, the EBRD in London and the World Bank. The same holds for Hungary and Latvia, equally two EU members with multi-year IMF-led macroeconomic stabilisation programs in operation.

What could be the short to medium-term repercussions of the Greek fiscal and public debt crises for its neighbours? Is the contagion risk limited or imminent? Some spillover effects have already started to manifest themselves. As Greek 10-year bonds fall and yields continue to remain above ten percent, sovereign debt issuance and the risk premium investors demand to hold securities issued by Romania, Serbia, Bulgaria and Turkey have been adversely affected.

Moreover, the ripple effects of the Greek crisis are being felt in three other key areas, namely the impact on foreign trade volumes, the level of remittances being sent back home from Greece and the cost of lending by the local subsidiaries of Greek parent banks operating in the region.

As the 2009 reporting season for commercial banks illustrates, they are being confronted with mounting problems concerning non-performing loans in Greece and in their main external markets, i.e. next door in Serbia, Romania and Bulgaria in particular. They are increasing the level of provisions, which reflect declining asset quality (e.g. in NPLs) and it will impact their profitability for 2010/11. Moreover, such provisioning also adversely influences available capital for banks' lending activities in Serbia, Romania, Albania, Bulgaria and FYR Macedonia. A return to annual lending growth rates reaching 50 percent and more, as seen across the region until 2008 will not be repeated by commercial banks, in particular from Greece and Austria, the Netherlands and Italy.

Despite the challenges they are facing in their domestic and external markets, Greek banks have participated in the "Vienna initiative" (see Chapter 1 and 4). They are committed to maintaining their exposure to these countries, even if this takes place with considerable financial assistance through multilateral financial institutions such as the EBRD, which is providing critical capital resources to Greek subsidiaries in the region for onward lending to enterprises in Bulgaria, Romania and Serbia.

We also have to bear in mind that the recession-hit markets in South East Europe still have a long way to go until they can legitimately claim to be on safer economic grounds. The secondary effects of the global economic and financial sector crises in the region are feeding through the real economies of these countries, e.g. in terms of declining consumer demand, indebtedness of private households and corporate entities as well as growing unemployment. Under these difficult conditions, the economic crisis in Greece risks affecting the recovery potential of its neighbours. Over the past decade foreign direct investment from Greece, rising trade volumes with each other and labour migration to Greece all contributed to assist the economic transition of its neighbours. This positive impact may be put on hold for some time to come.

However, possibly the most important issue on the minds of policy makers and central bank governors in neighbouring countries are the potential consequences for the most crucial political project in the region. There is a growing concern across capital cities from Tirana over Skopje to Belgrade and Ankara that the EU accession perspectives for countries in South East Europe could be affected as a result of the EU becoming rather cautious about enlargement and more rigorous regarding economic conditionalities of membership.

It is in this area of foreign policy making where Greek leadership will be most crucial in the coming months. Sending out clear signals of engagement with the region, sustaining these with practical efforts of support for its neighbours can underscore this crucial message: Despite the crisis and the challenges it poses, Greece will not become inward looking nor forget its neighbours!

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Susan Schadler was a Senior Associate Member of St Antony's College and Associate with the South East European Studies at Oxford (SEESOX) during 2010. Susan Schadler had been Deputy Director at the European Department of the IMF. She managed staff teams carrying out surveillance of both emerging and advanced European countries and supervised staff teams overseeing the IMF's lending operations in South East Europe. At the same time, she lead several long-term research projects formulating IMF positions vis-à-vis strategic decisions on euro adoption in the new members of the EU and growth strategies in central and South Eastern European countries. Descriptions of books resulting from these projects and her other publications can be found on her website www.susanschadler.com. Since leaving the IMF staff, Susan headed (for the IMF's Independent Evaluation Office) an evaluation of the IMF's involvement in international trade policy since the establishment of the WTO, consulted on international experiences with surges in capital inflows for the Asian Development Bank Institute, and contributed to a project at the National Bank of Poland considering costs and benefits of euro adoption.

George Kaoudis studied Statistics at the Athens University of Economics and Business and received a master's degree in Finance and Economics from the LSE. He worked as equity analyst for IDEAglobal London and as international markets analyst for the Private Banking Department of the Bank of Cyprus. He has been working in the Market Risk Section of the Financial Stability Department of the Bank of Greece since July 2009. He is a certified analyst by the Bank of Greece and a certified derivatives market maker by the Athens Exchange - Derivatives Market. **Vassilis Metaxas** (M.Sc. in Economics at LSE) has worked for Doxiadis Associates as a development consultant. He joined the Bank of Greece in 1992 and has served in the Government Financial Operations and Accounts Department and the Department of Economics Research. Since January 2009, he works at the Macro-prudential Analysis Section of the Financial Stability Department. **Nikolaos Stavrianou** (Msc in Economics at LSE) started his career as a consultant at Planet Ernst & Young and McKinsey. He joined BoG in 2004, worked 4 years for the Banking Supervision Department and since 2008 he has been working at the Macro-prudential Analysis Section of the Financial Stability Department. **Dimitrios Tsoudis** (MSc in Banking and International Finance) has worked in the past for three years as a tax advisor at KPMG. He joined Bank of Greece in July 2009 and since then he is working for the Macro-Prudential Analysis Section of the Financial Stability Department. **Angelos T. Vouldis** holds a Ph.D in Computational Mathematics (National Technical University of Athens) and an M.Sc. in Economics (University of Athens). He currently works in the Financial Stability Department, Bank of Greece.

South East European Studies at Oxford (SEESOX) is part of the European Studies Centre at St Antony's College, Oxford. It focuses on the interdisciplinary study of the politics, economics and societies of South East Europe, and the region's interaction with Europe. Drawing on the academic excellence of the University of Oxford and an international network of associates, it conducts academic and policy relevant research on the multifaceted transformations in the region and on the historical and intellectual influences which have shaped perceptions and actions in this part of the world. In Oxford's best tradition, the SEESOX team is committed to understanding the present through the longue durée and reflecting on the future through high quality scholarship.

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