

Edited by **Will Bartlett** and **Vassilis Monastiriotis**

South Eastern Europe after the Crisis

a new dawn or back to business as usual?



THE LONDON SCHOOL
OF ECONOMICS AND
POLITICAL SCIENCE ■

LSEE
Research on
South Eastern Europe

South East Europe after the Economic Crisis: a New Dawn or back to Business as Usual?

Edited by

Will Bartlett and Vassilis Monastiriotis



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PART A: THE IMPACT OF THE CRISIS IN SOUTH EAST EUROPE

CHAPTER 1: Introduction

Will Bartlett and Vassilis Monastiriotis

Background

In common with other transition economies, the economies of South East Europe (SEE) have suffered from the impact of the global recession more than most other regions around the world (Mitra et al., 2009). However, while some countries within the SEE region have been very deeply affected, others appear to have been relatively lightly touched by the crisis. While GDP fell in 2009 in Romania by 8%, Albania escaped relatively unscathed with positive, albeit reduced, growth in the worst recession year (see Table 1 which shows data for SEE countries covered by the EBRD). The effects of the crisis have been deeper than most analysts thought at the end of 2009. For example, compared to the 2010 GDP growth forecasts produced by EBRD at the end of 2009, by mid-2010 the institution had significantly downgraded its growth forecasts especially for Croatia, Romania and Macedonia, although the forecasts for Bulgaria and Serbia were upgraded slightly, while Turkey had a large upgrade. Using the latest estimates for 2010 GDP growth, the average expected growth over the three years 2008-2010 has been negative for Croatia and Bulgaria, and zero for Romania. It is notable that these include EU member states and a candidate state, all of which are highly economically integrated into the EU along many relevant dimensions. Average growth over the three years is expected to be sluggish for the other countries of the region, with the sole exception of Albania.

For the SEE region, the global financial crisis was experienced as a huge external shock. As the SEE banking systems were not directly exposed to 'toxic assets', the crisis was transmitted to the region through a number of indirect channels. These included a contraction of international trade, a sudden stop to credit growth, a rapid fall in inflows of foreign direct investment (FDI), and a rapid fall in remittances from migrant workers, each reflecting the impact of the global crisis in financial markets, goods markets, capital markets and labour markets. It is notable that these mechanisms mattered to different degrees in different countries in the region.

Table 1: Real GDP growth rates in SEE (% p.a.) (sorted by final column)

| | 2008 (EBRD end 2009) | 2009 (EBRD end 2009) | 2010 EBRD estimate (end 2009) | 2010 EBRD estimate (mid 2010) | Revision to 2010 growth estimate in percentage points | Average growth rate 2008-2010 (latest estimate) |
|------------|-------------------------|-------------------------|---|---|---|---|
| Bulgaria | 6.0 | -6.0 | -1.5 | -1.2 | +0.3 | -0.5 |
| Croatia | 2.4 | -5.4 | 1.5 | -1.3 | -2.8 | -0.5 |
| Romania | 7.1 | -8.0 | 1.0 | -3.0 | -4.0 | 0.0 |
| Turkey | 1.1 | -6.0 | 3.0 | 5.9 | +2.9 | 0.3 |
| Serbia | 5.4 | -4.0 | 1.0 | 1.9 | +0.9 | 0.8 |
| Bosnia | 5.4 | -3.1 | 0.8 | 0.4 | -0.4 | 1.0 |
| Montenegro | 7.5 | -4.1 | 0.1 | -0.1 | -0.2 | 1.2 |
| Macedonia | 4.9 | -1.6 | 2.0 | 0.5 | -1.5 | 1.8 |
| Albania | 6.8 | 3.0 | 1.6 | 1.4 | -0.2 | 3.8 |

Source EBRD online data end 2009 and mid 2010

The sudden and sharp collapse of global trade in late 2008 affected all countries, more so those which had higher trade integration with the EU than other SEE countries, such as Croatia and Romania. A wide variety of exchange rate regimes are used by the countries of the region, ranging from unilateral euro adoption (Kosovo, Montenegro), currency boards (Bulgaria, Bosnia), managed floats (Croatia and Serbia), hard pegs (Macedonia), and floating exchange rates (Albania). Countries which were able to allow their currencies to depreciate, such as Albania and Serbia, seem to have weathered the immediate consequences of the crisis more favourably than those which maintained fixed exchange rates. However, Macedonia which raised its policy rate from 7% to 9% to defend its peg to the euro when the crisis began at the end of 2008 has also done relatively well, as has Kosovo with the euro as its currency. The common denominator in crisis impact seems to be the degree of integration to the global and especially the EU economy, rather than the exchange rate regime as such. Nevertheless, in countries with fixed exchange rates the recovery could be slower than elsewhere, as it will take more time to adjust domestic wages and prices to restore international competitiveness to recover lost export markets (EBRD 2009).

An important transmission mechanism has been the global restriction of credit, which has affected those SEE countries with a high penetration of foreign banks. Over the last decade, foreign banks were eager to establish subsidiaries in the region where there were profitable opportunities to extend loans to both the household sector and the enterprise sector due to the relatively high returns available in emerging markets with underdeveloped financial systems. The countries most badly affected by the sudden stop in credit expansion have been Croatia, Bulgaria, Romania and Serbia all of which had rapid credit growth before the onset of the crisis. As Pavle Petrovic explains

(see chapter 12), the sudden stop in credit growth from foreign banks operating in Serbia had a far greater negative impact on growth than did the effect of the slowdown in trade. This was due to the fact that Serbia's export share in GDP was low even before the crisis. The impact of the crisis on the SEE region would most likely have been much greater if it had not been for a concerted and effective policy response from international institutions, involving coordinated agreements between international institutions and commercial banks to ensure continued lending to the region (the so-called Vienna Agreement).

Over the last decade, foreign investors found extensive opportunities, besides the banking sector, in telecommunications, energy and other sectors opened up by privatisation. Bulgaria, Croatia, Romania, and Turkey had greater prior dependence on inflows of FDI than other countries and so suffered the most from the falling global supply of investment capital. On the other hand, countries of the Western Balkans had in any case been relatively unsuccessful in attracting FDI and so there was relatively little impact from this source.

Some countries that were little affected by the slowdown in credit growth and FDI inflows in the initial stage of the crisis have been subsequently hit hard by the impact on European labour markets and the knock-on effect on remittances. Countries such as Albania, Bosnia and Herzegovina, Kosovo, Moldova and Serbia have been especially vulnerable to the later downturn in remittances, due to the lagged effect of the recession on European labour markets where many migrant workers from the region have lost their jobs. Remittances have so far held up in Albania and Serbia, while they have fallen sharply in Moldova and Romania. This may partly explain the sharp fall in GDP in these two countries in 2009.

Overall, the 'growth model' of reliance on rapid credit growth, FDI inflows, and labour export has been called into question by the economic crisis. The crisis has brought the economic growth of the last decade to a sharp halt, and the consequences in these weak economies have significantly affected people's everyday lives, through increased unemployment, rising prices of imports, restricted access to credit and increased levels of poverty in the region (for a detailed analysis of the poverty impact in Bosnia and Herzegovina see World Bank 2009)

Economic recovery appears to be following a variety of patterns too. The recovery has been slower than expected, perhaps in part because although few countries were impacted by the early stages of the financial crisis itself, most have been affected by the consequences of the subsequent collapse of

trade, credit, FDI and remittances. In particular, Bulgaria, Croatia and Romania are now expected to remain in recession for a second year, as credit growth and FDI inflows are unlikely to resume soon due to the impact of the global crisis on risk preferences and on capital supply. Even though global trade has recovered, and has pulled other countries of the region out of the worst of the recession, most seem likely to experience a slow and hesitating recovery. Only Albania, Kosovo and Turkey appear to be returning to strong economic growth in 2010.

Policy responses to the crisis have been varied, depending on the nature of the transmission mechanisms and the pattern of the subsequent recoveries. In some cases, such as Croatia the response of the monetary authorities has been important in mitigating the effect of the crisis by cancelling earlier restrictions on banks' lending to the domestic economy in foreign currencies (Bokan et al., 2009). The practical impact has been to run down domestic foreign currency reserves in the face of the collapse in the external supply of foreign funds. How long such a policy can be sustained is open to question. Other governments, such as those of Albania, Macedonia, Montenegro, and Turkey have allowed fiscal deficits to widen to support aggregate demand. Of course this can also only be a temporary solution, and presages further retrenchment of the economies in the future as fiscal deficits are curtailed and debt is paid off. Yet others such as Bosnia and Herzegovina, Romania and Serbia have negotiated Stand-by Agreements with the IMF to support their external deficits during the recovery period. For example, IMF support for Romania involved a €20bn package to finance a stabilisation programme jointly with the European Commission. Whichever has been the format of the policy response, the underlying weaknesses of the SEE economies means that these can only be temporary solutions, which rely on a relatively speedy return to the normal functioning of the global economy. If this does not occur, then more fundamental reforms will need to be put in place to ensure the resumption and sustainability of future economic growth on the region.

The real lesson of the economic crisis seems to be that the days of easy growth are over, and new policies must be designed and introduced to cope with the new realities. These will involve much delayed reforms in some countries, including structural reforms to improve the business environment and competitiveness, as well as institutional reforms to improve the functioning of the judicial system, reduce the shadow informal economy and tackle the widespread problems of institutionalised high-level corruption, as well as embedded organised crime, which in some countries undermines the trust relations and the confidence needed to underpin modern economic growth. Effective policies should also be based upon a rethinking of the growth model followed by

the countries in the region. For many years domestic growth relied on increased exports and an expansion in domestic demand facilitated through external injections (FDI inflows, financial assistance from the EU, remittances, and credit expansion in the banking system). The inflow of such resources led to an asymmetric expansion in consumption and the creation of external debts, trade deficits and a low savings rate – which made the SEE economies more vulnerable to external shocks. Moreover, trade openness facilitated the expansion of predominantly labour-intensive and low value-added specialisations, which may compromise the growth potential of the region in the longer-run. The type of foreign investments that entered in the region also contributed to this. Indeed, as the chapters of this book show, these asymmetries have been partly responsible for the intensity, as well as the variability, of the crisis in the region. Countries with more diversified trade and domestic demand that was not financed predominantly by external borrowing seem to have suffered less; countries with high external (private and public) borrowing and high export dependency from the EU were much more affected. In a way, then, the ability of the SEE countries to address these asymmetries, by strengthening domestic savings and trade diversification (especially towards intra-regional trade) is as important for the sustainable recovery of the region as is addressing problems of corruption and implementing structural reforms. This raises also a question about the role of the EU and of the association process more generally, as some of the above problems have been intensified, not mitigated, by the fast orientation of the region towards the EU markets and policies.

These issues, and the varied impact of the economic crisis in the SEE region, are analysed in more depth in the chapters that follow. The first three chapters provide an overview of the impact of the crisis on the region, and the policies which have been adopted in response to it. They range from the optimistic (Sanfey and Zeh – chapter 3) to the pessimistic (Kekic –chapter 4). It remains to be seen which of these views will be borne out in the future. Whatever the outcome, the social consequences are likely to be severe (Slay - chapter 2) and to last for many years to come, requiring continued assistance from the EU to mitigate the worst effects of the crisis and to speed up the EU accession process.

The rest of the book is devoted to a set of country chapters specially commissioned from experts within the region. They provide a detailed insight into the specific issues which affect the various countries, and demonstrate the important role of initial conditions and pre-crisis policies in channelling the global crisis into the domestic environment. Yet, although the transmission

mechanisms have been different, what clearly emerges from the different analyses is the profound adverse impact of the economic crisis on Europe's weakest economies. This adverse impact is likely to linger on much longer than anyone expected even a year ago, and calls out for the deep analysis provided by the authors of the following chapters to identify appropriate policies to mitigate the dire effects of the crisis on people's lives in one of Europe's poorest regions.

It should be noted that the contributions in this volume are rather diverse, varying not only in their emphasis on different aspects of the crisis but also in the assumptions underpinning their analyses. Some authors emphasise more the role of economic institutions and policy. Some insist more on the importance of structural reforms. Yet, others focus more on socio-cultural aspects, including thrust, social solidarity and the fight against corruption. Similarly, some authors assign to politicians and the public self-centred attitudes and motives. Others emphasise the distortive role of ethnic and national affiliations and divisions. Some appeal to the altruism and solidarity of society for overcoming economic calamities and achieving economic and social progress. Yet, others take a more pessimistic view of the public as inherently irrational and unable to pursue collective welfare-improving strategies. Naturally, the solutions proposed by the various authors also differ. They range from free-market pro-deregulation approaches, to proposals for socially-sensitive and equitable economic restructuring and modernisation; and from calls for top-down policies that seek to overcome possible collective action problems, to calls for more participatory and inclusive solutions to existing economic and social problems. As editors, we have not taken a view on these approaches and underlying assumptions, but rather we have allowed the authors the freedom to offer their insights without such constraints. Admittedly, this creates a discrepancy in the focus and style of the country chapters and thus the analyses provided in each of these are not directly comparable. But it also helps reveal the plurality and diversity of views and approaches that are being formulated, even within what is a relatively small and homogenous region (at least with regard to the impact of the crisis and the future trajectory of the countries concerned). It is in bringing out this diversity, not only of country experiences but importantly also of perceptions of these experiences, that we believe this volume makes its most important contribution.

Chapters in the book

Our overview of the impact of the crisis in SEE starts with the important contribution of Ben Slay (chapter 2), which covers both the economic and social impacts of the crisis. Concerning the economic dimension, while he presents a rather sanguine view about the growth prospects of the region, he argues that the region should be able to recover well if exports growth returns. On the

human development dimension, however, he suggests that outcomes may continue to worsen as unemployment is expected to increase further even if recovery takes place in 2010. Poverty trends may continue to deteriorate in consequence. There are also serious questions about the fiscal sustainability of social programmes, pensions, and public health care. Slay raises questions about the levels of public and external debt, which although relatively low by international standards, are vulnerable to falling FDI and reduced export demand. Consequently the socio-economic problems thrown up by the crisis are expected to worsen in the years ahead.

In chapter 3, Peter Sanfey and Simone Zeh focus more on the policy dimension and the policy outlook, providing a careful analysis of the characteristics that transmitted the crisis into the region and their implications. They start by showing how the crisis hit the region hard with an average decline in real GDP of 5.8% in 2009. They then analyse the role of specific factors such as exposure to foreign trade, FDI dependence, credit expansion and others in explaining the depth of the crisis across the region since, and conclude that large scale inflows of capital and FDI which fuelled growth in the 2000s are unlikely to continue to be a strong driver of growth in the 2010s. They conclude that recovery from the crisis in SEE will depend upon improved trade performance, and especially upon achieving greater trade integration within the region (which is already facilitated by the removal of trade barriers through the signing of CEFTA2006) as a means for strengthening the competitiveness of the countries concerned and thus improving their trade performance also at the multilateral level.

Laza Kekic, in chapter 4, examines the prospects for recovery from another prism, by investigating the potential consequences of the Greek crisis for the region. Starting from the observation that economic recovery in the region is expected to be weak and fragile, he offers a rather more pessimistic analysis and argues that there is an additional risk for a second recession in the region if Greek banks reduce their exposure due to liquidity pressures on the parent banks in Greece – especially in countries such as Albania, Bulgaria, Romania and Serbia, where their involvement is particularly high. Greek subsidiaries in the region are largely funded by loans from Greek parent banks, rather than by domestic deposits, and are thus probably less likely to make new loans in the region in the future, contributing to a likely slowing growth of credit in the next few years.

Turning to the country chapters, Etleva Germenji (chapter 5) discusses the impact of the crisis in Albania. The country was the only one which did not experience falling GDP in 2009, although the growth rate was cut in half from 6% in 2008 to 3% in 2009. She highlights why and how the contagion spread, and shows that the relatively moderate impact of the crisis on Albania was due to

limited integration into global markets, and that the low level of financial market development kept the country relatively isolated from the financial meltdown. The economy was nevertheless affected, mainly due to adverse spillovers in remittances, exports and tighter domestic financial conditions. Albania is distinguished by having a large proportion of the population working abroad, with almost one million working in Greece and Italy, and with remittances accounting for 10% of Albania's GDP. The main impact of the crisis was therefore felt in a reduction in remittances. Nevertheless, the fiscal deficit jumped from 3% of GDP in 2007 to 7% in 2009, public debt increased to 60% of GDP, international borrowing costs rose sharply, and the government experienced difficulty in raising new finance on international capital markets. Echoing the concerns of Kekic in chapter 4, Germenji expresses worries over potential spillovers from the economic crisis in Greece, and doubts that the expenditure-based approach and fiscal stimulus practiced by the government will be sufficient to eliminate increasing uncertainties over the prospects for the sustainability of rapid economic growth in the future.

In chapter 6, Domazet emphasizes the political economy of the crisis, arguing that while political elites have so far stalled essential reforms, this strategy is no longer an option. The sources of growth which hitherto relied on economic liberalisation and capital inflows from abroad supported by remittances is no longer available. Bosnia is caught in a "middle income trap" in which real wages and unit labour costs are too high to support international competitiveness based on a low wage, low skill economy, while the lack of innovation, low investment in education, and absence of real structural reform have prevented the economy from developing along a competitive path based on high value-added export led growth. Now the political elite are faced with the choice between sustainable recovery based on fundamental structural and constitutional reform, and a scenario in which the economy fails to benefit from future growth in EU markets and experiences a prolonged period of slow growth, increasing unemployment, falling levels of human development, and political instability.

In chapter 7, Stoyan Totev points to the fixed exchange rate embedded by the currency board system as a reason for the slow recovery of the Bulgarian economy. The crisis had a profound impact in Bulgaria where the stock market collapsed by 87% in 2008, remittances have fallen sharply, and unemployment rose with some lag, to 10% in early 2010, exacerbated by the return of unskilled migrant workers from abroad. FDI has been especially oriented towards the housing and construction sectors where investments are more mobile and short-term, and thus with the onset of the crisis the country experienced significant capital outflows while inward FDI collapsed, dropping

by over 50% in 2009 alone. The crisis has had political fallout too, in revealing the depth of corruption and bribery; it has made a realignment of political forces more likely.

Katarina Ott's discussion of the case of Croatia (chapter 8) starts by arguing that the crisis has hit the country hard and that policy makers were not prepared for it – having allowed public and private expenditures to exceed the country's productive capacity leading to a build up of international and domestic imbalances well before the economic crisis hit home. However, the government has since responded strongly, with the introduction of an Economic Recovery Programme, and a corresponding Action Plan. Ott approves of the Plan's contents which include the intention to reduce the role of the state in the economy, structural reforms, public administration reform, reduced budget expenditures, a simplification of the tax system, reductions in state aid and the introduction of a fiscal responsibility law. However, while the required reforms have been spelt out in the programme, the political ability to carry them out still appears doubtful, given the unwillingness of voters to support such changes. Ott emphasises the political resistance to change, but argues that all citizens should accept the need to 'take the medicine' in the interest of economic recovery and future prosperity. Evidence of backsliding on the provisions of the programme is already evident with the government failing to stand up to political pressures from trade unions and other pressure groups including pensioners and war veterans. The weak judicial system and the low transparency of the public sector are additional obstacles to reform and recovery.

In chapter 9, Petrit Gashi discusses the impact of the global economic crisis on Kosovo. He shows that Kosovo has been little affected by the global economic crisis since it has a very low degree of economic integration with the international economy. FDI is extremely low, and Kosovo exports little to the rest of the world. With exports only one-tenth the level of imports, Kosovo has an enormous trade deficit, which is covered by inflows of official international assistance and the remittances from the large number of migrant workers, accounting for an estimated 14% of GDP. The financial impact of the crisis has been minimal as the banking sector in Kosovo is embryonic, even though largely foreign owned, with loans more than covered by domestic deposits. However, the growth of credit, mainly channelled to the enterprise sector, has slowed down sharply in the crisis period. Gashi argues that the main impact of the crisis is likely to be transmitted through falling remittance transfers as unskilled Kosovar migrants working abroad are very vulnerable to downturns in the European labour markets where many of them are employed. Fortunately the crisis coincided with a major public investment programme which supported demand and, as in Albania, ensured positive

output growth in 2009. Gashi concludes that prospects for future economic growth depend upon a far greater economic integration of the Kosovo economy into European markets

In chapter 10, Trajko Slaveski presents an analysis of the impact of the economic crisis in FYR Macedonia. Unlike other countries in the region, the impact on the Macedonian economy was modest, with a fall in GDP of just 1% in 2009. Structural reforms and sensible monetary policies enabled the economy to adapt to the crisis with limited adverse effects on the government's fiscal position. In addition, the country's banking system was in a favourable position at the onset of the economic crisis, as the share of foreign assets was low and the banks relied mainly on domestic deposits. Slaveski discusses the possible impact of the Greek sovereign debt crisis on Macedonia, and concludes that it may well be serious as the trade and investment relations between the two countries are rather strong, despite the political impasse over the 'name issue'. He argues that in the future Macedonia, as well as other Balkan countries, will need to adapt their economic systems to put greater emphasis on productivity growth and international competitiveness, since the growth factors which have played an important role over the past decade such as easy supply of credit and growing FDI inflows are unlikely to resume in the near future. In addition the role of the EU pre-accession programmes is seen as more important than ever in supporting the economic recovery in the country.

In chapter 11, Veselin Vukotić argues that the era of high optimism that accompanied the rapid growth of the Montenegrin economy after 2000 has come to an end. Deep structural problems in the small economy of the country have been revealed, in particular the excessive reliance on the public sector as a source of employment and the unbalanced relationship between the tradable and the non tradable goods sector, meaning that the export capacity of the economy is low. Montenegro has experienced relatively high inflows of foreign investment into non-tradable sectors such as housing and finance over the last decade. This has now come to an abrupt halt. The response to the crisis requires a complete rethink of how to conduct economic policy. Yet a reliance on increased state intervention is unlikely to be of much use in a small open economy such as Montenegro. Vukotić proposes the continuation of a liberal economic policy approach based on an open economy, but one in which the share of the state is much reduced, most future employment is generated in the private rather than the public sector, and an improved education system is put at the fore of building international competitiveness.

Ileana Tache and Cristina Neesham report, in chapter 12, on the impact of the economic crisis in Romania. They point to the enormous build up of debt that accompanied economic growth in Romania in the years prior to the onset of the economic crisis. Large capital inflows led to a strong appreciation of the local currency, which undermined international competitiveness. In addition the share of foreign currency loans that increased many times over during the period of rapid growth up to 2008 was the 'greatest vulnerability' of Romania's economy in the pre-crisis period. Fiscal profligacy in the boom years created yet more vulnerability in the economy. As it was, the economic crisis had an enormous impact in Romania, leading to a drop of GDP of 8% in 2009. In addition to improved fiscal management, reduced public expenditure and continuation of the current tight monetary policies, the authors argue that structural reforms (especially streamlining social security and improving education and research and development) are the preconditions of recovery from the economic crisis. The authors additionally recommend that recovery measures should include improved allocation of public funds based on performance and efficiency and a focus on effective infrastructure development.

In chapter 13, Pavle Petrovic points to the sudden stop in credit expansion in 2008 as a major effect of the global economic crisis in Serbia. As the country begun its economic reforms late, foreign banks had only recently started expanding their activities there, leading to a rate of credit expansion of 20% per annum before the onset of the crisis. Once the crisis hit, foreign credit growth ceased, causing a contraction of the economy. Other factors were similar to the other SEE countries, including the collapse of demand for exports from the EU and other global markets, although this was a secondary factor in the Serbian case since trade integration of the economy was low. As a consequence of the recession, unemployment has jumped to from 15% in 2008 to almost 20% in 2010. Nevertheless, in terms of output the recession was not too severe, with GDP declining only by a relatively modest amount in 2009. Petrovic attributes this to a careful and well-managed depreciation of the dinar (by some 25% since 2008) which avoided a rapid fall in its value in view of the high degree of euroisation of the economy – 70% of all loans are denominated in Euros. In contrast to Croatia, which defended the value of its currency, the resulting output fall was far lower in Serbia. The backing of a €3 billion IMF Stand-by Arrangement, together with the Vienna Agreement which supported the banking sector, prevented a possible currency collapse which loomed on the horizon. Nevertheless, the impact on public finances has been heavy with a growing public sector deficit. Serbia has responded by freezing public sector pay and cutting government expenditure in the midst of the recession, causing a drag on economic recovery, and thus government debt continues to rise, threatening the sustainability of the recovery. The risks are high,

considering the expiry of the IMF support at the end of 2010, and the forthcoming elections in 2011 which, according to precedent, may be preceded by a public expenditure splurge to catch votes. All this gives great importance to the improvement of the international competitiveness of the economy and emphasises the need for an export led recovery.

Future prospects

The countries of South Eastern Europe have been affected in quite variable ways by the economic crisis. Some countries such as Bulgaria, Croatia, and Romania have been hit hard, while others such as Albania, Kosovo and Macedonia appear to have got off more lightly, so far. To some extent this reflects the degree of integration into EU markets. Policy responses to the crisis have been varied, depending on the nature of the transmission mechanisms and the pattern of the subsequent recoveries. In Croatia the response of the monetary authorities has been to cancel restrictions on bank lending to the domestic economy in foreign currencies. The practical impact has been to run down domestic foreign currency reserves in the face of the collapse in the external supply of foreign funds. How long such a policy can be sustained is open to question. Other governments, such as those of Albania, Macedonia and Montenegro, have allowed fiscal deficits to widen to support aggregate demand. Of course this can also only be a temporary solution, and presages possible further retrenchment of these economies in the future as fiscal deficits are curtailed and debt is paid off. Yet others such as Bosnia and Herzegovina, Romania, and Serbia, have negotiated Stand-by Agreements with the IMF to support their external deficits during the recovery period.

However, while the worst effects of the crisis appear to be over, it is likely that for all the countries it will take many years before the unemployment and spare capacity in the region is absorbed and the process of recovery can be said to be fully underway (World Bank 2010). Furthermore, the social impact of the crisis is likely to be long-lasting, as the impact on unemployment, incomes, and poverty will persist long after economic growth has recovered (see chapter 2 by Ben Slay). In addition, as government budget constraints become even tighter than hitherto, there will be reduced capacity to support the relatively generous social protection systems which have been maintained in at least some of the countries, such as Bosnia and Croatia in particular. Improved targeting of social assistance benefits may be part of the answer here, but it can be doubted whether this is politically or administratively feasible. In countries with less well developed systems of social assistance and social protection such as Albania and Kosovo, the reliance on the informal economy is unlikely to diminish. Several authors in this volume have emphasised the need for improvements to the education and training systems in the region as an essential means to improve

international competitiveness that will underpin a recovery in export earnings and enhance the region's attractiveness to foreign investment. Yet, continued restrictions on public expenditure make the attainment of this desirable objective appear as a rather remote possibility.

Moreover, many countries especially Albania, Bosnia, and Kosovo, are highly reliant on remittance incomes. If EU labour markets become more restricted as a result of the political pressures emanating from the crisis then the reduction on remittance flows will cause even further delay in the economic recovery. In relation to this, high levels of labour export may actually have reduced the pressure on policy makers to improve the education systems in the countries concerned, relying on on-the-job training and the education systems in the host countries as proxy means to improve the skills of at least the mobile part of the labour force.

The speed with which recovery takes place depends on how far previous growth was dependent on abnormal credit growth and FDI inflows which are unlikely to resume, and how far other factors, such as trade and remittances, may return to previous levels in the near future. The role of trade recovery is likely to be critical, and in this respect the opportunities arising from increased regional trade and other forms of regional cooperation are likely to be a significant factor. Of course, it is unlikely that the region will be able to pull itself up by its own bootstraps. If this idea, first proposed many years ago by the Austrian economist Rosenstein Rodan who argued for a coordinated approach to economic development (a 'big push') that would overcome negative spillovers among the small countries of the region, has not been possible in 'good times', it is unlikely that it will be sufficient by its own in the current conjunction, let alone generate the necessary political support – although it is in times of crises that such policy shifts become possible. So while this emphasis on a coordinated approach is important, not only in relation to non-economic factors such as corruption and organised crime but also with regard to trade relations and factor flows between the countries, it is unlikely that real recovery will take place without the deep structural and political reforms that are extensively identified by the contributors to this book.

Perhaps even more importantly, the region's recovery also depends crucially on the role that the EU will assume in the future. Two factors seem especially important. The first is the extent to which it will support the continuing involvement of the foreign, mainly EU-based, banks in the region and its own continuing support for economic restructuring there. The second is the extent to which it will assist countries to avoid the imbalances created in the past, owing to various forms of dependence (economic, on trade, aid and FDI, as well as political) which in some respects may have intensified

problems of corruption and governance in the region. A continued commitment to the enlargement agenda is vital in this respect to ensure a continued incentive for political elites to pursue the economic and institutional reforms that are needed. This is so, despite the fact that in the process of EU accession many of the institutions that have been established are not necessarily appropriate to the conditions in the less developed and transition countries of the region. The various 'Agencies' and other types of institutions that have been created often appear to be merely designed to tick the compliance boxes of the pre-accession process, resulting in the creation of fake institutions, and in only partial compliance with the rule transfer mandated by the EU (Noutcheva 2009).

The economic crisis in the EU has led to a great sense of enlargement fatigue, and indeed has heightened concerns about the stability of the eurozone system and the willingness of EU countries to engage in cooperative solutions to the crisis within the EU itself. This has led to a rise in the political antipathy even towards migrants from within the EU, as evinced by the recent spat within the EU institutions over French policy on Roma immigrants from Romania, which has involved mass expulsions of Roma since July 2010. This moreover reminds us that 'ethnic cleansing' is not a merely Balkan phenomenon. Whether such inward looking and self-serving approaches will spill over into significant delays in the enlargement agenda is a real possibility, which can only be a negative factor in the future economic recovery prospects for the countries of South Eastern Europe. The recent creation of the €750 billion European Financial Stability Facility, designed to provide emergency budget and balance of payments support for eurozone countries which experience difficulties in accessing international capital markets due to heightened default risk, is a good example of a more cooperative approach to solving EU problems. The crisis has shown that negative spillovers can adversely affect the core European countries just as well as the peripheral countries. It is to be hoped that this awareness will also inform a wider regional cooperation which takes on board the collective interests of the whole of Europe, including its South Eastern part, in the future.

Overall, the 'growth model' of reliance on rapid credit growth, FDI inflows, and labour export has been called into question by the economic crisis. The crisis has brought the economic growth of the last decade to a sharp halt, and the consequences in these weak economies has significantly affected people's everyday lives, through increased unemployment, rising prices of imports, restricted access to credit and increased levels of poverty. All this means that the pace of EU integration will most likely slow down, as countries are pre-occupied with their own recovery programmes. The international organisations and the EU have provided some assistance to the region. The European Economic Recovery Plan called for support for the economic and social consolidation of the

candidate countries and the Western Balkans in the mutual interest of the EU and the region. To this end the Commission put in place a € 120 million “Crisis Response Package”, leveraging an amount of € 500 million in loans from International Financial Institutions.

Whichever has been the format of the policy response, the underlying weaknesses of the Western Balkan economies means that these can only be temporary solutions which rely on a relatively speedy return to normality of the global economy. If this does not occur, then more fundamental reforms will need to be put in place, and a less externally-dependent growth model will have to be pursued, to ensure the resumption and sustainability of future economic growth on the region. The real lesson of the economic crisis seems to be that the days of easy growth are over and new policies must be designed and introduced to cope with the new realities. These will involve much delayed reforms in some countries, both structural (to improve the business environment and competitiveness) and institutional (to tackle institutionalised corruption and organised crime, reduce the shadow economy and improve the functioning of the judicial system), that will help restore the trust relations and the confidence needed to underpin modern economic growth. But it will also involve a shift away from relying on external demand (for exports) and supply (of capital) towards strengthening internal links and developing functional complementarities that can enhance not only the short-run growth prospects of the region but, more importantly, its economic resilience in the longer-run. Either way, in a much more short-term perspective and in addition to the above, if the EU is serious about extending the promise of eventual EU membership to the countries of the Western Balkans, it should also further extend the scope of the European Financial Stability Facility to those countries as well.

CHAPTER 2: The macroeconomic and social impact of the global financial crisis on South East Europe

Ben Slay¹

Overview

This paper provides a brief overview of the macroeconomic and socio-economic impact of the global recession on the economies of Southeast Europe.² Particular attention is devoted to trends in GDP, employment, external and fiscal balances, as well as monetary and social policy responses. This overview suggests that the economies of this region have generally fared better than members of many comparator groups, including both “new” and “old” member states of the European Union, and many of the transition economies in the former Soviet Union. Two of the seven economies examined here (Kosovo and Albania) reported GDP growth in 2009; for the others, declines in GDP were rather mild. And while the fiscal data available for 2009 have a preliminary character, they suggest that policy makers in Southeast Europe were generally able to reallocate fiscal resources towards social services and social protection, cushioning the blow of the crisis for at least some of the most vulnerable households and regions.

On the other hand, GDP for this region as a whole almost certainly declined in 2009, marking the end of nearly a decade of strong or accelerating growth in household incomes and employment. Sharp declines in capital inflows caused reductions in domestic demand to exceed declines in GDP, with commensurately greater impacts on consumption and living standards (present and future). The numbers of unemployed workers and unemployment rates rose across the region; and income poverty levels almost certainly increased—particularly for vulnerable groups. Recent UNDP research indicates that the human development impact of the crisis on the transition economies of Europe and Central Asia can be expected to occur with a lag, suggesting that even a return to GDP growth in 2010-2011 may not be sufficient to prevent further increases in income and non-income poverty

¹ The author would like to thank Balázs Horváth, Marija Ignatevic, Peter van Russeyfeldt, and participants at the Joint Vienna Institute’s March 2010 Policy Research Conference on “The Global Crisis: Economic Challenges and Lessons for Southeast Europe” (<http://www.jvi.org/index.php?id=20137>). The views expressed in this paper are the author’s, and are not necessarily those of UNDP, the United Nations, or its member states.

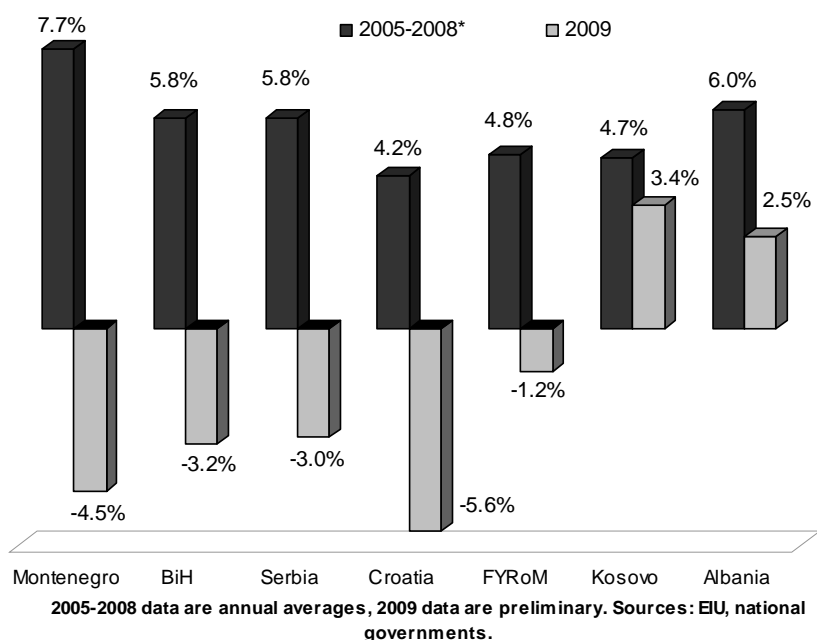
² Understood as the economies of Albania, Bosnia and Herzegovina, Croatia, Kosovo (as per UN Security Council Resolution 1244), the Former Yugoslav Republic of Macedonia, Montenegro, and Serbia. New EU member states, and Turkey, are not considered in this paper.

levels. And while resources seem to have been redeployed in support of social protection, it is not clear that these increases were well targeted toward the region's most vulnerable households.

Macroeconomic trends: What actually happened in 2009?

As the data in Figure 1 indicate, GDP growth in Southeast Europe slowed, stopped, or turned negative in 2009.³ The most recent projections for last year (published during January-February 2010) suggest that the best growth performance was registered in Kosovo (3.4%) and Albania (2.5%); the other economies registered GDP declines in the 3-6% range. Taken as a whole, these data suggest that the region's euro-denominated GDP declined by some 4%. Available GDP end-use data imply that consumption declines were generally greater than the reported reductions in GDP, as sharp declines in imports produced growth in net exports that further reduced domestic demand. On the other hand, as shown in Figure 2, these GDP trends compared favourably with those reported by many other economies, including some from the EU-15 (e.g., Finland, Ireland), the EU-10 (e.g., the Baltic states, Romania, Slovenia) and the Former Soviet Union (e.g., Ukraine, Russia, Armenia, Moldova).

Figure 1: GDP trends, 2005-2008 and 2009



³ Except where stated otherwise, data in this paper come from the most recent national EIU and IMF country reports, from Eurostat and national bank web sites, and from the ECFIN 6 January 2010 *EU Candidate and Pre-accession Countries Economic Quarterly*. These data are not always consistent, particularly for 2009; in such cases, some of the numbers in this paper are UNDP estimates. Many of the 2009 (and some earlier years') data have a preliminary character, and could undergo significant revisions in the months ahead.

Figure 2: 2009 GDP declines in Southeast Europe, other European countries

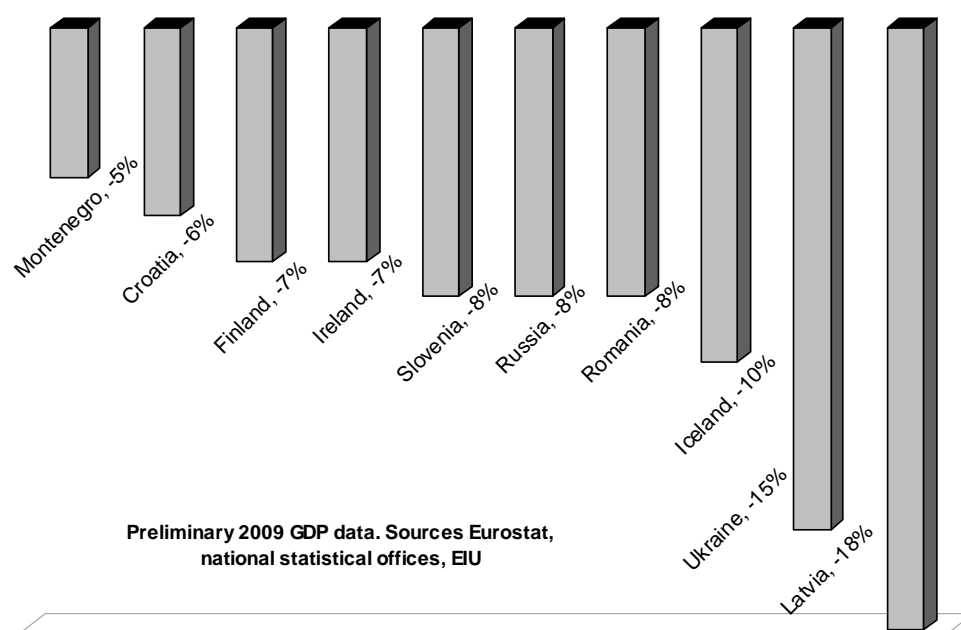
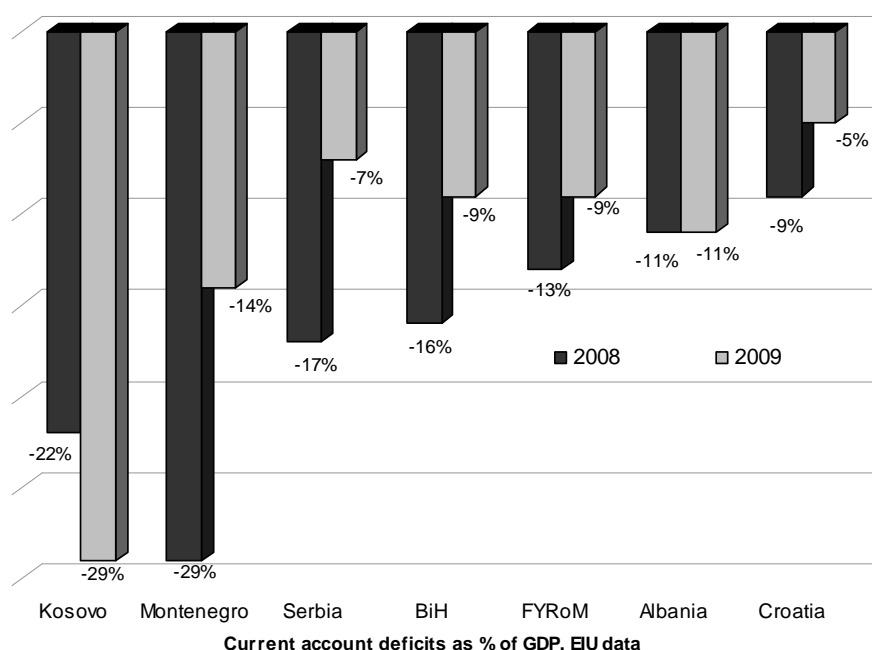


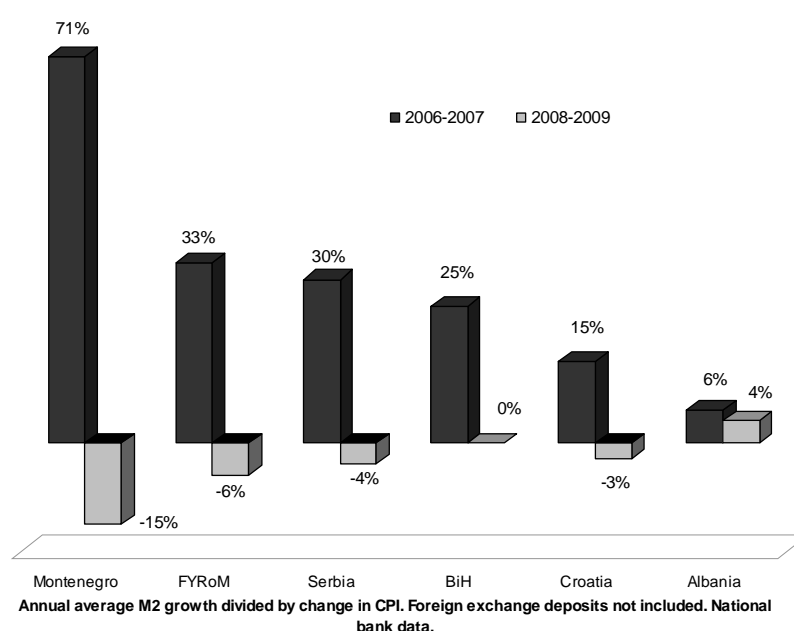
Figure 3: Current account deficits, 2008-2009



These output trends reflect a number of drivers. On the negative side, demand for exports to key EU markets (Germany, Italy, Austria, Greece) fell with the global recession. However, even larger relative declines in capital inflows (reflecting financial market instability) generally caused sharp reductions in current account deficits—many of which had grown quite large (see Figure 3). These

had previously facilitated rapid pre-2008 money supply growth (see Figure 4). The continuation of GDP growth in Kosovo and Albania was in no small measure made possible by the fact that sharp external adjustments were avoided. For the other economies, reductions in net capital inflows and financial sector distress tightened money and credit conditions during 2008-2009, putting downward pressures on fixed investment and interest-sensitive household spending. This was the case both for the euroized economies and for those whose national currencies depreciated in 2009.

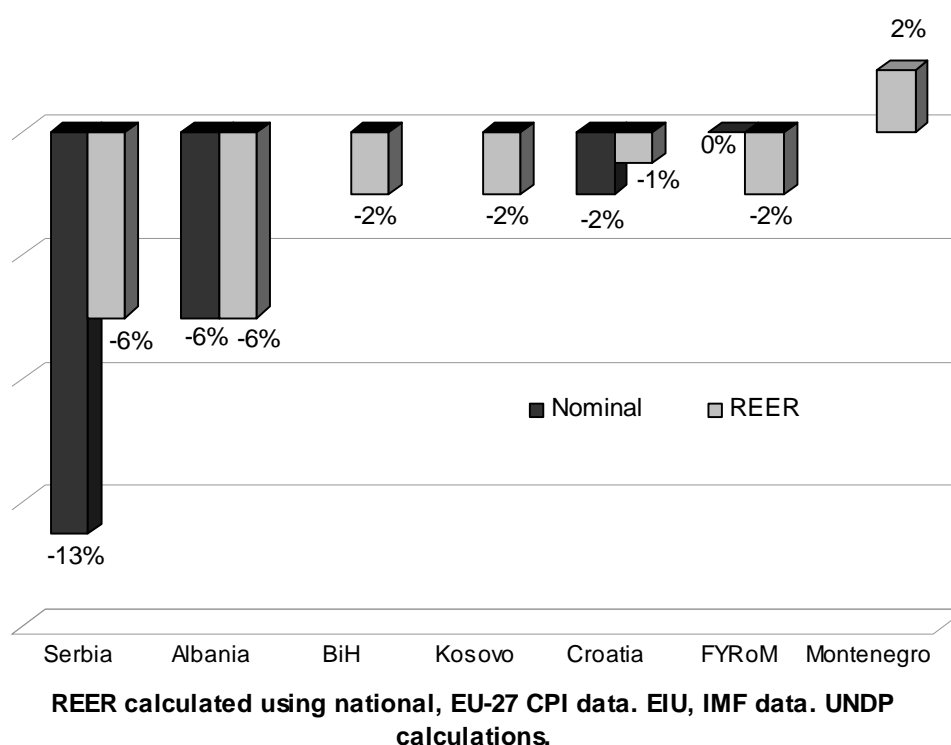
Figure 4: M2 growth trends, in real terms (2006-2009)



On the plus side, pre-crisis reforms of banking systems, the sale of most significant domestic financial institutions to European banks (generally completed prior to the onset of the crisis), the Vienna process (the IMF-led cooperation between West European banks and governments, which involved a collective response to financing gaps in emerging Europe), and relatively low public and external debt levels (Croatia is an exception) prevented full-blown banking crises.⁴ Moreover, as the trends in Figure 5 show, even euroized Kosovo and quasi-euroized Bosnia and Herzegovina reported real effective exchange rate depreciations in 2009, thanks to deflationary pressures that helped safeguard competitiveness. Larger short-term declines in living standards were prevented by the fact that fixed investment generally seems to have declined more sharply than household or (especially) public consumption.

⁴ For more on these issues, see Maechler and Ong (2009).

Figure 5: Changes in nominal, real effective exchange rates (2009)



The macroeconomic policy response

Fiscal policy was the response instrument of choice: all the Southeast European economies experienced growing fiscal deficits in 2009 (see Figure 6). With the exception of Croatia, these increases were relatively large: in Montenegro, for example, the general government budget balance went from a surplus of 3.4% of GDP in 2008 to a deficit estimated to be above 6% of GDP in 2009. Relatively low public debt levels in the region, automatic fiscal stabilizers supported by relatively large shares of GDP redistributed via the public sector (see Figure 7), and the practical absence (in Bosnia and Herzegovina, Kosovo, and Montenegro) of discretionary monetary and exchange-rate policy instruments made reliance on fiscal policy responses inevitable. This fiscal loosening was generally judged by the IMF as consistent with macroeconomic realities and therefore not inconsistent with Fund programmes (actual or potential).⁵ While these increases reflected discretionary fiscal and social policy decisions (particularly in Albania and Kosovo), they also reflected the impact of automatic stabilizers that boosted social protection expenditures and reduced budget revenues as tax bases (and tax discipline) shrank.⁶

⁵ In addition to the on-going Fund programme in the Former Yugoslav Republic of Macedonia, new standby agreements were introduced in 2009 for Bosnia and Herzegovina (\$1.5 billion) and Serbia (\$4 billion).

⁶ These revenue decreases often occurred in spite of increases in the rates of value added taxes and other levies that are relatively easy to collect.

Figure 6: Fiscal balances (2006-2009)

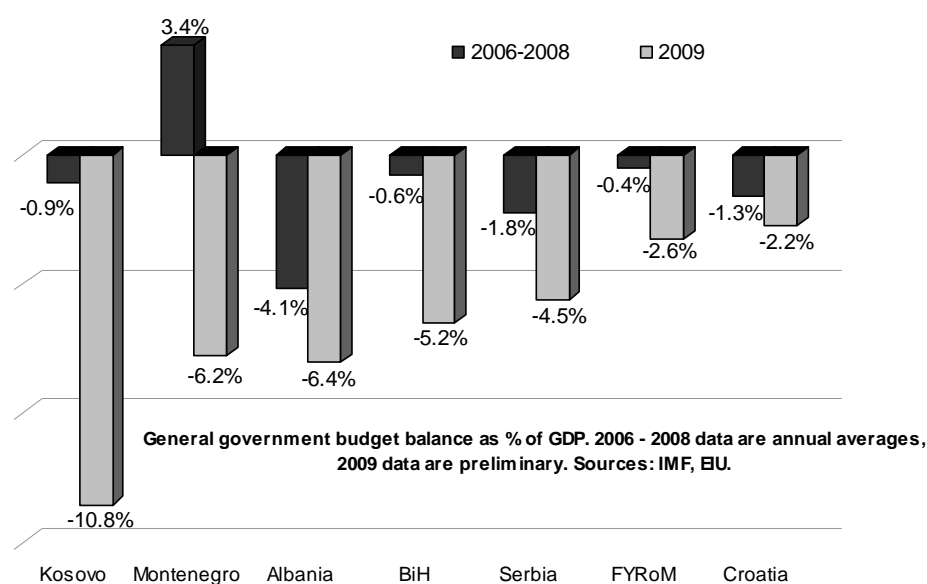
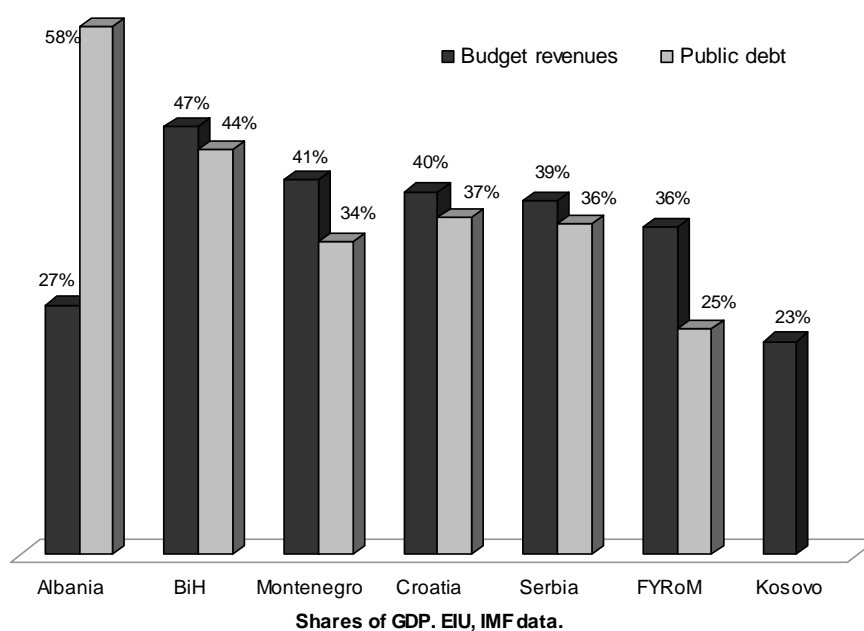


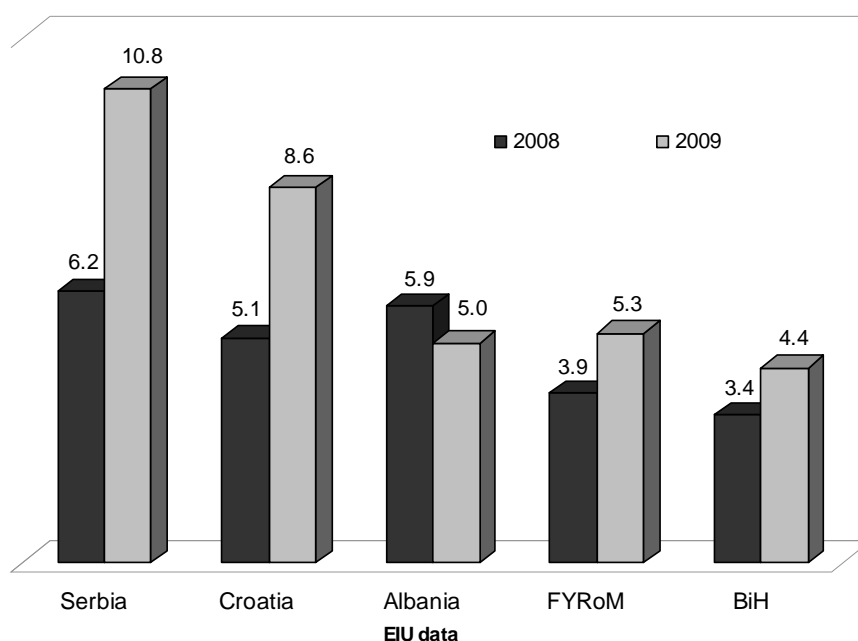
Figure 7: Budget revenues, public debt, as shares of GDP (2009)



The countries with relatively flexible exchange rate regimes (Albania, Croatia, and Serbia) took advantage of global deflationary conditions to devalue their currencies with minimal inflationary pass-through (Serbia was something of an exception). At the same time, these devaluations were

not so large as to place excessive stress on unhedged euroized bank and corporate balance sheets.⁷ While the data in Figure 4 suggest that the monetary contraction in these economies was less than in euroized Kosovo and Montenegro (as well as *de facto* euroized Bosnia and Herzegovina), only in Montenegro did we see a truly abrupt monetary adjustment (at least, as measured by real M2 trends). Much of the monetary tightening shown in Figure 4 occurred during the fourth quarter of 2008, when banks across the region experienced significant withdrawals from household accounts. By the end of 2009 most of these pressures had eased. And while central and commercial bank reserves fell across the region during 2008-2009, thanks to large declines in imports and continued access to international credit lines (generally from parent banks in EU-15 countries) import coverage generally improved in 2009 (see Figure 8).

Figure 8: Months of import coverage by official foreign exchange reserves (2008-2009)



Despite the increases in public debt generated by the fiscal expansions, all the Southeast European economies continue to report public debt levels that are below (and except for Albania, well below) the 60% of GDP reference point in the EU's Stability and Growth Pact. Likewise, thanks in large measure to the privatization campaigns pursued prior to 2009, significant shares of the region's large current account deficits had been financed by FDI inflows, preventing the appearance of dangerously high external debt levels. (This is another area in which pre-crisis macroeconomic trends in Southeast Europe were healthier than in the Baltic states and some other transition

⁷ This is particularly an issue in Croatia, where private-sector liabilities account for the lion's share of the country's external debt.

economies.) Policy makers in Southeast Europe during 2010-2011 may not face the same binding fiscal and external constraints confronting policy makers elsewhere (although Kosovo⁸ and Bosnia and Herzegovina may constitute exceptions).⁹ Whether social policy institutions in Southeast Europe have the capacity to use this fiscal space to protect those most vulnerable to the socio-economic impact of the crisis is a different matter.

Socio-economic impact and social policy response

In contrast to macroeconomic indicators, data on poverty, inequality and social exclusion in Southeast Europe are not sufficiently robust or comparable to permit quantifiable statements about the social impact of the crisis on the region as a whole. The most recent methodologically comparable data on income poverty and inequality is for 2005; these come from the World Bank's POVCALNET data base,¹⁰ and are shown in Tables 1 and 2 below. These data are not without their problems, both in terms of coverage (internationally comparable data for Kosovo, Montenegro, and Serbia are missing) and in quality. These include both generic problems of international comparisons of income and poverty levels,¹¹ and some other problems specific to this data base, such as the: (i) reconciliation of multiple poverty estimates for a given year via arithmetic averaging (irrespective of the variance across these estimates); and (ii) presentation of income poverty data during the pre-1990 period for individual Yugoslav republics, at a time when the capacity to collect these data is widely seen to have been wanting. Perhaps their most serious drawback is that these data stop at 2005 — three years before the onset of the crisis.

⁸ The IMF's most assessment of Kosovo's economy argues that "Fiscal policies are adrift—policy priorities lack clarity and expenditure management is loose . . . Without substantial expenditure cuts, ad hoc deficit financing poses considerable risks to macro stability . . . substantial expenditure cuts are needed to restore fiscal sustainability . . . a credible anchor is needed to underpin fiscal policies and regain control—once and for all—over expenditures and the deficit." IMF(2009a)

⁹ IMF medium-term debt sustainability analyses for the region are more pessimistic, however.

¹⁰ These data are ostensibly collected from methodologically comparable household budget surveys measuring per-capita equivalized consumption expenditures (as proxies for income) for most of the world's developing and transition economies. These expenditure data are made comparable by the use of global purchasing-power-parity (PPP) exchange rates that were updated within the framework of the International Comparison Project. (See <http://web.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTRESEARCH/EXTPROGRAMS/EXTPOVRES/EXTPOVCALNET/0,,contentMDK:21867101~pagePK:64168427~piPK:64168435~theSitePK:5280443,00.html>.)

¹¹ These include differences in ostensibly identical goods included in different economies' minimal consumption baskets, the varying paces at which prices for goods and services included in these baskets undergo liberalization, and differing levels of household willingness to honestly answer interviewers' questions about their incomes and spending.

| Table 1—Poverty trends in Southeast European countries (PPP\$4.30/day threshold) | | | | | | | | | |
|---|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Country | 1981 | 1984 | 1987 | 1990 | 1993 | 1996 | 1999 | 2002 | 2005 |
| Albania | 48% | 47% | 43% | 63% | 63% | 50% | 48% | 58% | 48% |
| Bosnia and Herzegovina | 6% | 5% | 4% | 4% | 6% | 6% | 5% | 3% | 11% |
| Croatia | 0% | 0% | 0% | 0% | 1% | 1% | 2% | 2% | 0% |
| FYR Macedonia | 27% | 24% | 22% | 23% | 31% | 32% | 36% | 23% | 19% |

Source: World Bank POVCALNET database.

| Table 2—Income inequality trends in Southeast Europe (Gini coefficients) | | | | | | | | | |
|---|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Country | 1981 | 1984 | 1987 | 1990 | 1993 | 1996 | 1999 | 2002 | 2005 |
| Albania | 0.29 | 0.29 | 0.29 | 0.29 | 0.29 | 0.29 | 0.29 | 0.28 | 0.33 |
| Bosnia and Herzegovina | 0.28 | 0.28 | 0.28 | 0.28 | 0.28 | 0.28 | 0.28 | 0.28 | 0.36 |
| Croatia | 0.23 | 0.23 | 0.23 | 0.24 | 0.25 | 0.26 | 0.28 | 0.31 | 0.29 |
| FYR Macedonia | 0.28 | 0.28 | 0.28 | 0.28 | 0.28 | 0.28 | 0.31 | 0.39 | 0.39 |

Source: World Bank POVCALNET database. Based on household consumption expenditure data.

These caveats aside, the POVCALNET data suggest the following conclusions. First, they underscore the differences in poverty levels and living standards (most of which were inherited) in the region. Thus, using the PPP\$4.30/day threshold proposed by the World Bank to measure income poverty in the Europe and Central Asia region, these data indicate that the income poverty rate in Croatia was close to zero in 2005—comparable to the rates reported in most EU member states. Second, these data suggest that income poverty levels in these economies in 2005 were roughly comparable to the pre-1990 levels (somewhat better in the Former Yugoslav Republic of Macedonia; somewhat worse in Bosnia and Herzegovina; roughly the same in the other cases). The robust post-2005 GDP growth (see Figure 1), combined with the surprisingly strong (albeit uneven) growth in employment and in budget expenditures on social protection, social insurance, and social services reported across Southeast Europe during this time (see Figures 9, 11), suggest that income poverty rates had fallen further prior to the onset of the crisis. The national poverty data that are available tend to support these conclusions. In Albania, for example, the share of the population with real per-capita monthly consumption expenditures below the national poverty line fell to 12% in 2008, from 18.5% in 2005 (and 25% in 2002). In Bosnia and Herzegovina, the World Bank estimates that the absolute poverty rate fell from 17.7% in 2004 to 14% in 2007 (INSTAT 2009, World Bank 2009).

Figure 9: Employment trends (2005-2009)

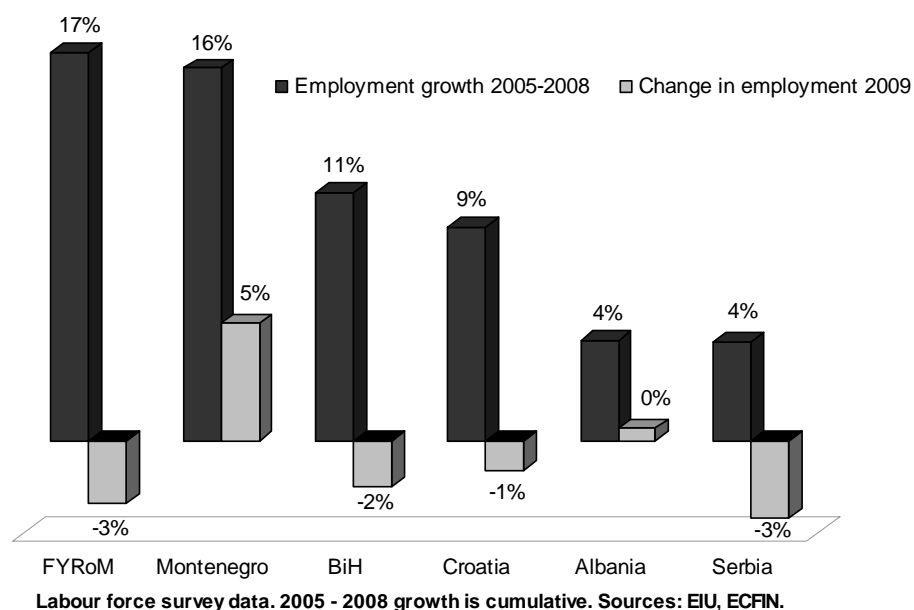
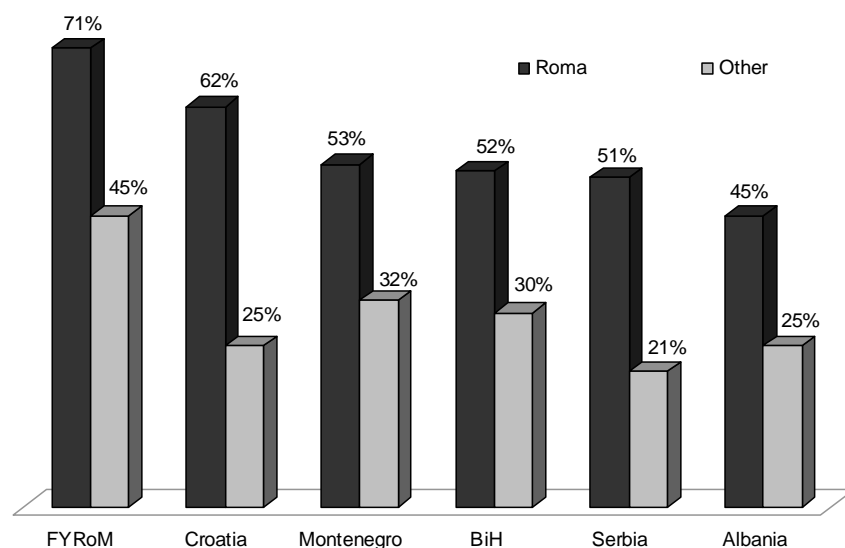


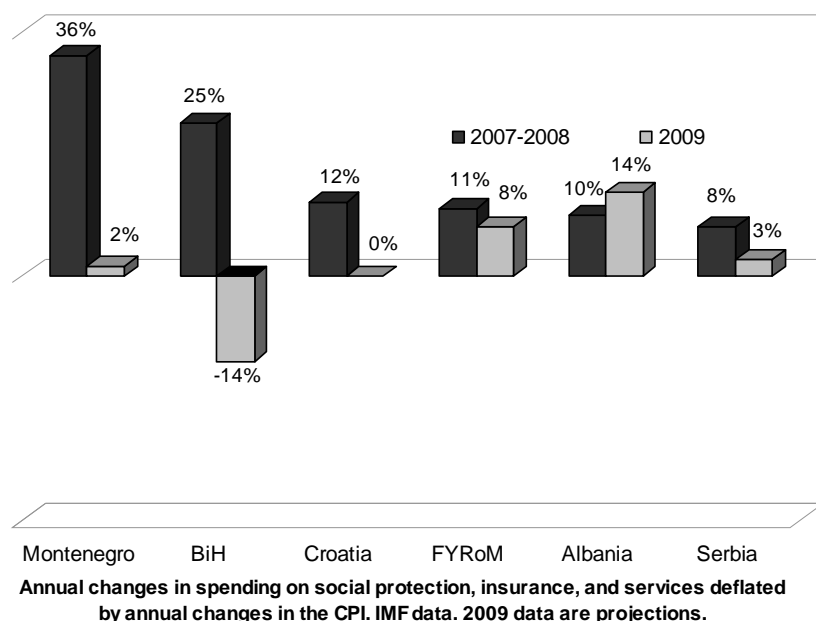
Figure 10: Unemployment rates for Roma, other workers (2005)



Collected by UNDP according to ILO methodology. Note: "Other" here refers to unemployment rates collected from surveys of "majority" communities living in close proximity to Roma settlements or neighbourhoods.

Source: *At Risk: Roma and the Displaced in Southeast Europe*, p42.

Figure 11: Social expenditure trends (2007-2009)



On the other hand, the POVCALNET data also indicate that income inequality (as measured by Gini coefficients) increased across Southeast Europe (see Table 2)¹²—particularly after 1999—when the strong recoveries from the transition recession began. Unless they were reversed during 2006-2008, these data suggest three important implications. First, while the pre-crisis economic growth may have lifted many households out of poverty, it may also have left many people in poverty. Second, these data raise questions about the effectiveness of social policy in Southeast Europe, in terms of poverty reduction. Third, they suggest that—rather than absolute material deprivation—it is pockets of relative poverty and social exclusion that should be of greatest concern to social policy makers. In fact, on-going UNDP research and publications underscore the importance of social exclusion—affecting particularly Roma communities (see Figure 10), but also other vulnerable groups (children in large families, the elderly living alone, women, other ethnic minorities, the displaced, residents of rural, remote, declining, peripheral or war-affected areas, the long-term unemployed, and workers with incomplete primary education)—as a development challenge in Southeast Europe.¹³

¹² These results are supported by a host of national and international studies. See, for example, <http://website1.wider.unu.edu/wiid/wiid.htm>.

¹³ See, for example, *At Risk: Roma and the Displaced in Southeast Europe* (UNDP, 2006); as well as national human development reports from Bosnia and Herzegovina (2006, 2007, 2009), Croatia (2007), and Montenegro (2009). These can be downloaded from <http://europeandcis.undp.org/home/browse/publications>. For more information on UNDP's upcoming regional human development report on social inclusion (to be launched later in 2010), see <http://europeandcis.undp.org/poverty/mdghdpm/show/9A4180A3-F203-1EE9-B931CBF6C6E4B7DF>.

How have social policy makers in Southeast Europe responded to the socio-economic impact of the crisis? Preliminary IMF fiscal data indicate that policy makers in Albania, the Former Yugoslav Republic of Macedonia, Montenegro, and Serbia managed to increase budget spending on social protection, insurance, and services—in real terms—in 2009 (see Figure 11). This suggests that, in fact, social policy makers did not necessarily have to “do more with less” during 2008-2009. Active labour market policies apparently helped maintain employment growth in Albania and Kosovo, and in Montenegro, in 2009.

In other respects, however, the successes of these efforts are open to question. A November 2009 World Bank publication found that Serbia was the only country in Southeastern Europe in which more than half of the poorest quintile of households received social assistance (based on 2007 data). In Bosnia and Herzegovina and Montenegro, the share was under 25% (Mitra et al., 2009: 164-5). As the World Bank points out, this is not an accident—principles other than protecting the most vulnerable drive social policy in Southeast Europe:

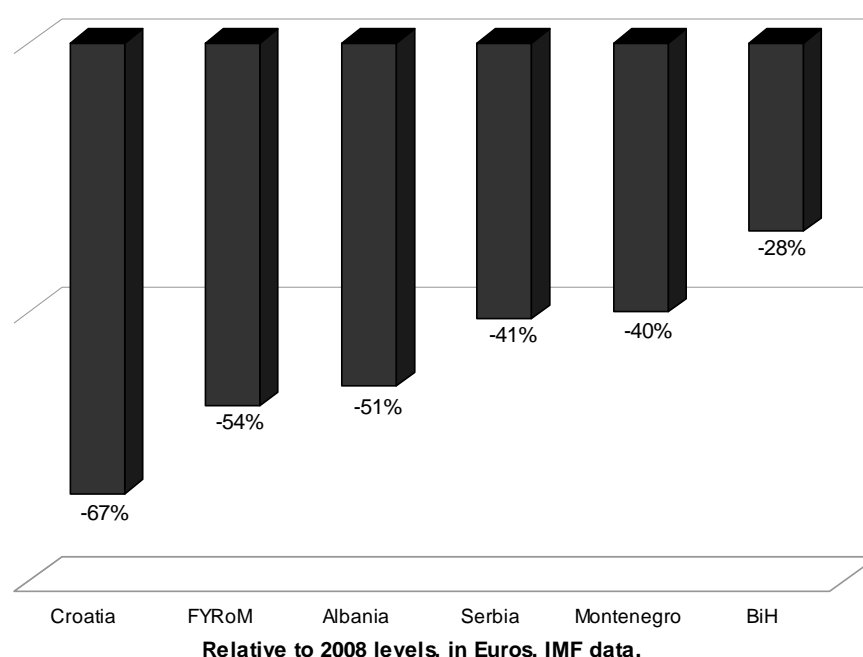
Bosnia and Herzegovina is among the highest spenders [in terms of shares of GDP devoted to social policy] but has rather low coverage, because many benefits are “rights based” rather than “needs based.” More than three-quarters of cash transfers are rights-based transfers. Safety nets in Croatia have a similar feature. Many of its programs cover war veterans, children’s allowances, and other family benefits that are not targeted. (Mitra et al., 2009: 165)

Social policy frameworks that reflect a lack of capacity (or desire) to protect those who are most vulnerable are hardly unique to Southeastern Europe; and reasonable individuals will disagree about the philosophical and practical merits of seeking to protect more or less vulnerable households from socio-economic adversity. Still, it seems likely that significant shares of the “crisis response” increases in social protection and social service spending in 2009 did not reach the most needy (Roma communities, the long-term unemployed, people living with disabilities, residents of under-developed regions). Likewise, if Southeast European policy makers do not possess effective instruments for directing social protection to the most vulnerable, the restraint they demonstrated in not permitting fiscal deficits to widen further in 2009 may be more understandable.

On the other hand, virtually all the Southeast European economies have undertaken significant social policy reforms during the last five years. These reforms (which have been supported by the

World Bank, European Commission, UNDP, and other partners) have generally sought to promote employment growth by liberalizing labour market regulation and by removing poverty traps created (unintentionally) by social protection legislation. They have also sought to align tax and social benefit systems with the region's unfolding demographic realities, and with the (sometimes still limited) administrative capacity of social policy institutions. These broader, systemic reforms have often been accompanied by more narrow initiatives focusing on specific vulnerable groups, such as Roma.¹⁴

Figure 12: Declines in foreign direct investment (2009)



Thanks in part to these reforms, the World Bank reports that virtually each Southeast European economy possesses at least one well-targeted social protection programme which, if they were to receive additional funds, could quickly and effectively reduce the impact of the crisis on vulnerable households.¹⁵ Better supporting those who are most vulnerable to the impact of the crisis in Southeast Europe may therefore hinge more on questions of philosophy and priorities than on social policy effectiveness. Moreover, the large numbers of Southeast Europe's elderly who do not receive

¹⁴ For more on these targeted programmes in Serbia, see Jelena Tadzic and Danilo Vukovic, "Roma in Serbia: Vicious Circles of Exclusion", *Development and Transition*, April 2010.

¹⁵ These are: Albania's Ndhima Ekonomike programme, Bosnia and Herzegovina's CPA programme, Croatia's Social Welfare programme, Kosovo's Social Assistance programme, the Former Yugoslav Republic of Macedonia's SFA programme, Montenegro's MOP programme, and Serbia's CA programme (*Ibid.*, p. 169).

any pension incomes (most of whom are women) suggest that social protection could be effectively strengthened via increased (self-targeting) pension coverage—if funding is indeed available.¹⁶

Conclusion

In a number of respects, Southeast Europe seems to have weathered the global economic crisis reasonably well in 2009. Preliminary data indicate that GDP continued to grow in some economies, while registering only mild declines in most others; financial panics, currency crises, and sharp increases in unemployment seem to have been avoided. If the 2010-2011 period sees a solid recovery in Southeast Europe's exports to (and capital inflows from) EU-15 economies, the region may survive the global traumas of 2008-2009 relatively unscathed.

As of early spring 2010, however, recovery trends in the EU-15 economies seem to be weak at best. If these trends were to continue throughout 2010-2011, Southeast Europe's prospects for an early return to pre-2009 levels of economic and employment growth would look rather dim. Moreover, recent UNDP research indicates that much of the human development impact of the crisis on the transition economies of Europe and Central Asia can be expected to occur with a lag—particularly in terms of labour market adjustment (unemployment as a lagging indicator) and budget-funded social protection and services. This suggests that even a return to stronger GDP growth in 2010-2011 may not be sufficient to prevent further increases in unemployment, and in income and non-income poverty levels.¹⁷

Preliminary 2009 fiscal data indicate that policy makers in most of the economies had access to significant fiscal space for responding to the crisis. This suggests that—at least in 2009—trying to “do more with less” was not necessarily the order of the day. It also raises questions about whether the extension of pension coverage to excluded groups could be an effective social policy response to the crisis. However, as in many other European countries, demographic and cost pressures on pensions, health care, and other social programmes in Southeast Europe raise questions about the medium- and long-term fiscal sustainability of these programmes.¹⁸ A prolonged recession could further

¹⁶ Other social groups that face complete or significant exclusion from pension coverage include agricultural workers, the self-employed, and other workers with irregular income (and social security contribution) streams. Roma often fall into this category.

¹⁷ See *The Human Development Impact of the Global Crisis in Central, Eastern and Southern Europe, and the CIS*, Balázs Horváth, Andrey Ivanov and Mihail Peleah, with Michaela Pospíšilová, UNDP Bratislava Regional Centre, November 2009.

¹⁸ While Albania enjoys more favourable (in this respect) demographic trends than other Southeast European economies, the greater extent of informality, and extensive quasi-fiscal deficits associated with the energy sector, and relatively large public debt levels (close to 60% of GDP) pose threats to fiscal sustainability not shared in other parts of the region (except in Kosovo).

exacerbate these tensions.¹⁹ In this sense, the region's relatively low public debt levels are misleading. Similar arguments could be made about the region's relatively low external debt levels: should the post-2008 combination of weak export growth and declining FDI inflows continue (see Figure 12), the region's external position could deteriorate rapidly. (In a scenario characterized by weak EU-15 GDP growth and FDI outflows, combined with the privatization of fewer attractive state-owned assets in Southeast Europe, such an outcome would not seem at all unlikely.) Longer term, the declines in fixed investment reported in the preliminary 2009 GDP data suggest lower future employment, living standards and competitiveness. In light of these issues, a return to annual GDP growth in the 1-2% range during 2010-2011 does not seem likely to redress the socio-economic effects of the crisis that Southeast Europe is now experiencing. Slow growth could also shrink the fiscal space needed for social policy response to the crisis—further raising the importance of better targeting in social policy and service delivery.

¹⁹ For more on this, see *Pensions in Crisis: Europe and Central Asia Regional Policy Note*, The World Bank, November 2009.

CHAPTER 3: Trade potential and long-run growth in SEE

Peter Sanfey and Simone Zeh

Introduction

South Eastern Europe (SEE) witnessed an unprecedented period of macroeconomic stability and economic growth during most of the past decade. This boom came to an abrupt halt in late-2008, when the global crisis hit the region with full force. Real GDP in SEE fell by an estimated 5.5 per cent in 2009. Although output seems to have stabilised (as of early-2010) and most countries expect modest economic growth this year, the prospects for a more sustained upturn are highly uncertain.

This paper argues that SEE can grow strongly again, provided it realises its trade potential. The argument is as follows: the main sources of growth in the past decade – capital inflows and expanded credit – are likely to be somewhat subdued in the coming years. However, trade flows, both within the region and externally, are still well below the level that might be expected from economies of this size. This partly reflects a big infrastructure deficit, but also the persistence of barriers to trade and weaknesses in the overall business climate. If these problems can be addressed successfully, the growth dividend could be substantial.

Background: Pre-crisis growth and the economic downturn

From 2000 to 2008, the SEE region experienced strong economic growth accompanied by rapid economic and financial integration into Western markets. These boom years were largely fuelled by huge capital inflows, mainly in the form of foreign direct investment (FDI), which rose steadily throughout the decade to a record of US\$ 32.5 billion in 2008 alone. Labour emigration created an additional and important supply of foreign currency inflows through remittances. Financial institutions were also a major driver behind the extraordinary economic expansion. Many foreign-owned banks entered the region during these years and domestic credit grew dramatically, causing sustained credit booms in almost all countries.

Figure 1. FDI in million of Euros

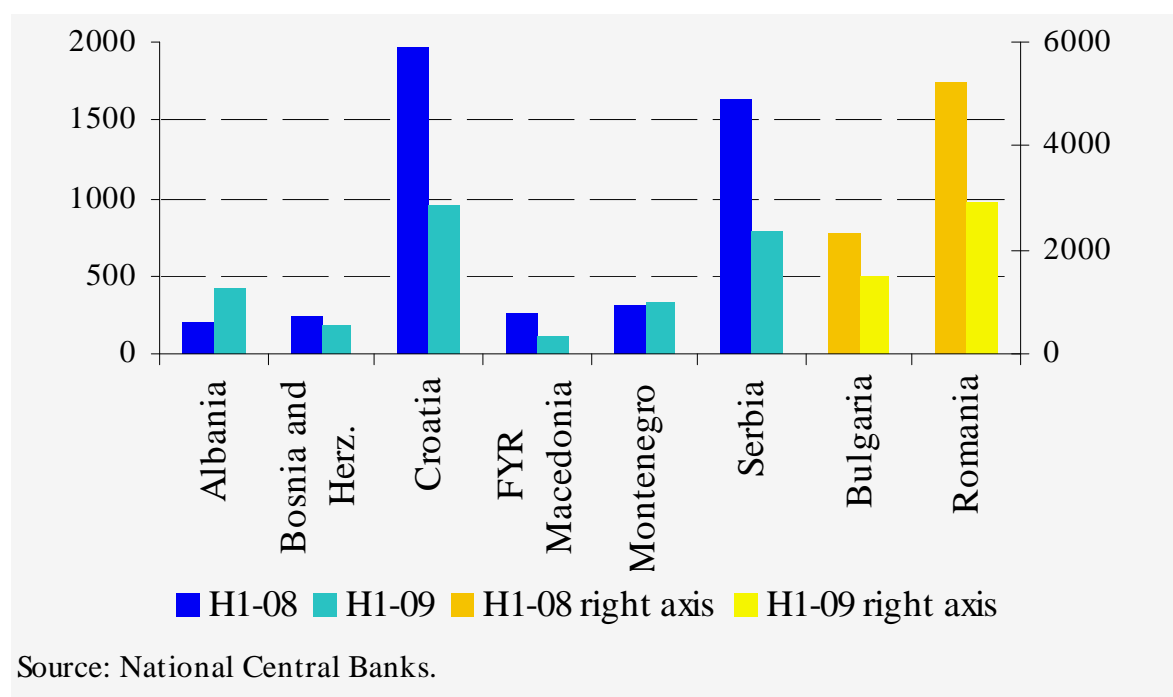
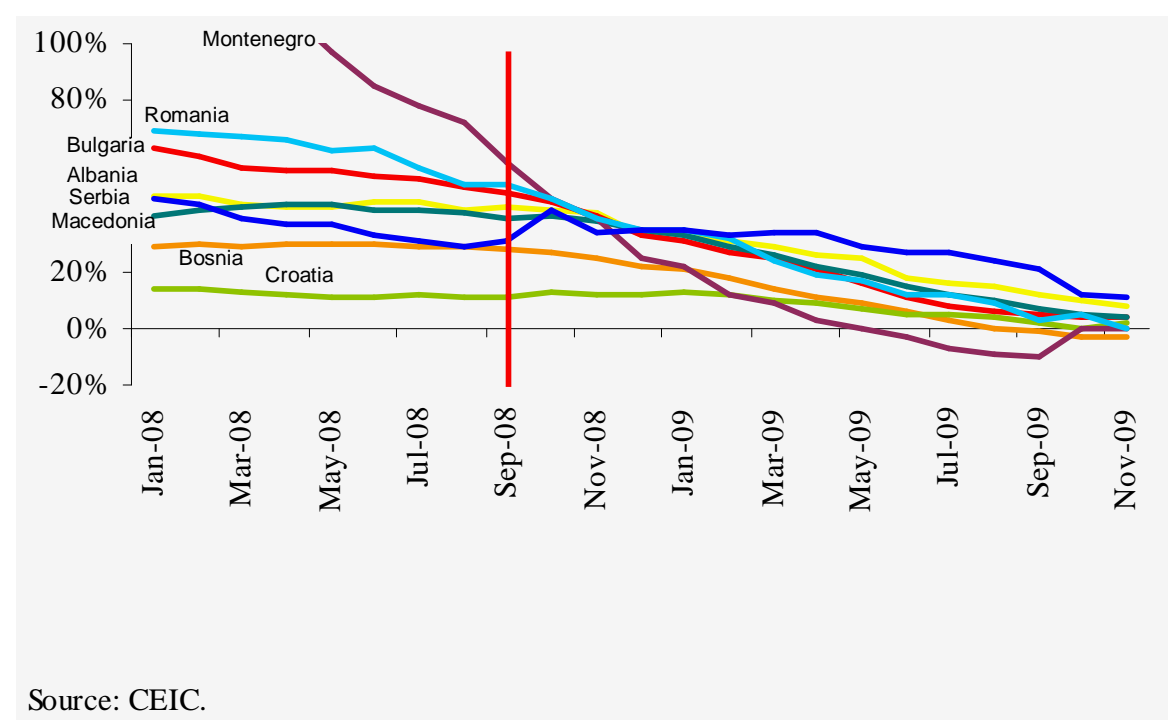


Figure 2. Evolution of credit growth in per cent



Since late-2008, there has been a dramatic turnaround in FDI and credit (in contrast, remittances appear to be relatively stable). Figures 1 and 2 show the extent of the decline in both variables. On average, FDI in the first half of 2009 dropped by around 41 per cent compared with the same period

in 2008 (see Figure 1). In parallel, current account deficits have been squeezed significantly, falling on average during the first three quarters of 2009 to about half of the previous year's levels (as a percentage of GDP). Meanwhile, credit slowed dramatically to single digit levels in most countries, whilst in Bosnia and Herzegovina, Croatia and Montenegro credit growth even turned negative in late 2009, as Figure 2 indicates. In the recession, banks have become increasingly concerned about asset quality, and the proportion of loans that are non-performing has risen steadily in the past year.

Trans-border trade as the future model for growth

The crisis has highlighted the vulnerabilities of the growth model on which SEE has relied in the past decade. Although signs of a modest upturn are now apparent in most countries, capital inflows and credit growth are likely to be subdued in the coming years. What then are the alternative sources of growth?

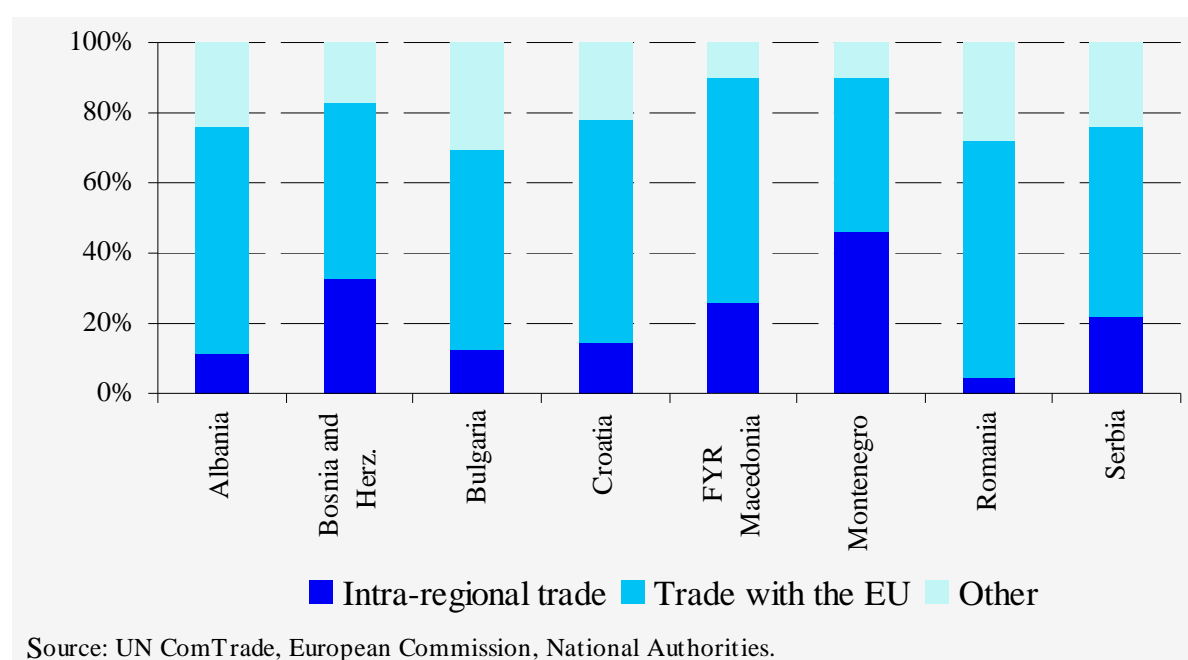
| Table 1. Share of Trade in GDP in 2008 in per cent | | | | | | |
|--|---------|----------|-----------|---------------|-----------------|----------|
| Albania | Bosnia | Bulgaria | Croatia | FYR Macedonia | Romania | Serbia |
| 40.17% | 94.68% | 122.41% | 65.17% | 108.17% | 65.10% | 67.69% |
| Estonia | Hungary | Latvia | Lithuania | Poland | Slovak Republic | Slovenia |
| 156.84% | 159.58% | 104.61% | 121.49% | 84.34% | 174.48% | 141.24% |

Source: IMF, National Bank of Serbia, EBRD.

Greater openness and expanding trade to both regional and European markets could be part of the answer. Although trade patterns within the region are traditionally closely linked and economic integration into the West has deepened in recent years, trade flows have remained limited in many SEE countries. One way of seeing this is to look at the level of “openness” – defined as the sum of exports and imports divided by GDP – for each country. Table 1 illustrates the ratio of openness of the SEE region. It ranges from 40 per cent in Albania, which historically is less integrated into international markets, to more than 100 per cent in Bulgaria and FYR Macedonia. Comparing these figures to those of the economies of Central Europe and the Baltic states (CEB), it becomes apparent that the degree of openness of SEE economies remains rather low.

In addition, an interesting feature of SEE trade flows is the comparatively low *intra*-regional flow of goods, in particular compared to trade with European markets. Taking an unweighted average across countries, in 2008 only around 20 per cent of total imports and exports were traded within the region, whereas around 57 per cent accounted for *inter*-regional trade with the European Union (EU), as illustrated in Figure 3. Compared to 2004 it further appears striking that trade within the region has only increased slightly from 16 per cent, in spite of a new CEFTA agreement entering into force in 2007.²⁰

Figure 3. Structure of total trade in SEE in 2008 in per cent



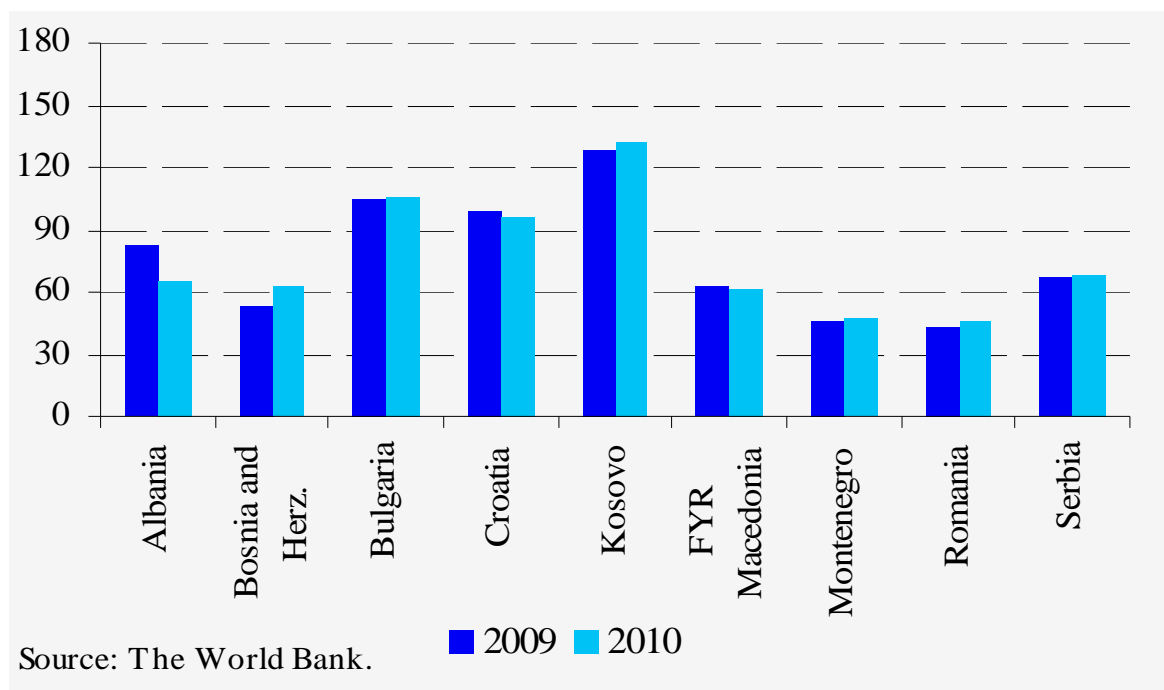
Why are trade flows below potential? The answer cannot lie in tariffs and quotas, as all SEE countries are either in the EU (Bulgaria and Romania) or have duty-free access to EU markets for most goods. But non-tariff barriers and obstacles to trade remain significant, as the following section shows.

²⁰ The so-called CEFTA 2006 was signed by Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia, Moldova, Montenegro, Romania, Serbia and the United Nations Interim Administration Mission in Kosovo (UNMIK) on behalf of Kosovo under UNSCR 1244 in December 2006. Bulgaria and Romania left CEFTA when they joined the European Union on January 1 2007. Inter alia, the agreement envisages trade liberalisation for manufactured goods and several agricultural products and additionally covers various areas related to NTBs, in particular technical barriers as well as sanitary and phytosanitary standards. For more information see: www.cefta2006.com

Obstacles to Trade

Cross-country surveys by institutions such as the World Bank and EBRD provide valuable insights into the type of problems that beset the region's business climate. Figure 4 shows how SEE countries compare in the 2009 and 2010 World Bank Doing Business Reports. It shows the ranking (from approximately 180 countries²¹) that each country achieves in terms of trading across borders.

Figure 4. Doing Business 2010: Trading Across Borders



The scores vary quite significantly across the region, with Kosovo experiencing the worst problems in both years (ranked 132nd in 2010). It is closely followed by Bulgaria and Croatia (ranked 105th and 96th respectively) while conversely, Montenegro (47th) and Romania (46th) have received the best scores within the region. Albania has made the most substantial progress, improving by 19 places in the past year, whilst cross-border trading in Bosnia and Herzegovina appears to have worsened the most as compared to 2009.

Table 2 provides a more detailed analysis. With the exception of costs to trading goods²², which has in fact increased in recent years (though in line with other regions) and a slight increase in the number of documents required to export, it appears that governments in SEE have had some success in facilitating the administrative procedures to import and exports. Comparing the results to

²¹ The survey includes 183 countries, with 1 representing the best and 183 the lowest score.

²² Expressed in US\$, fees levied on a 20-foot container.

the Doing Business 2007 survey, it shows that the time to exports and import²³ has been reduced substantially from 21.4 days to 16.1 and from 21 to 15.4 days respectively. However, a comparison to the CEB countries shows that SEE continues to lag behind significantly (except on time to import), and further efforts to catch up and comply with European standards are needed.

Table 2. Doing Business 2010: Trading Across Borders – Regional Comparison

| | Documents to export | Time to export | Cost to export | Documents to import | Time to import | Cost to import |
|--|---------------------|-----------------------|--------------------------|---------------------|-----------------------|--------------------------|
| Albania | 7 | 19 | 725 | 9 | 18 | 710 |
| Bosnia and Herz. | 6 | 16 | 1,125 | 7 | 16 | 1,090 |
| Bulgaria | 5 | 23 | 1,551 | 7 | 21 | 1,666 |
| Croatia | 7 | 20 | 1,281 | 8 | 16 | 1,141 |
| Kosovo | 6 | 12 | 1,436 | 6 | 11 | 1,420 |
| FYR Macedonia | 7 | 14 | 775 | 7 | 14 | 890 |
| Montenegro | 8 | 17 | 2,270 | 8 | 16 | 2,330 |
| Romania | 5 | 12 | 1,275 | 6 | 13 | 1,175 |
| Serbia | 6 | 12 | 1,398 | 6 | 14 | 1,559 |
| SEE average (averages in 2007) | 6.3 (5.9) | 16.1 (21.4) | 1315.1 (921.9) | 7.1 (7.9) | 15.4 (21) | 1331.2 (1097) |
| CEB average (averages in 2007) | 5.1 (5.3) | 15.0 (14.7) | 1032.4 (850.7) | 6.4 (6.1) | 17.5 (16.6) | 1084.4 (921.3) |

Source: The World Bank.

The EBRD/World Bank Business Environment and Enterprise Performance Survey (BEEPS), which is based on detailed interviews with enterprise owners and managers in the region, leads to a similar conclusion. In 2008, entrepreneurs being surveyed considered “Customs and Trade Regulations” to be no obstacle (=0) or a minor obstacle to business (=1), which gives the region a total (weighted) average score of 0.91 in 2008, compared to 0.93 in 2005 (see Figure 5²⁴). It appears that Albania made the most substantial progress in terms of removing custom and trade regulations, whereas attitudes of respondents in Romania and Serbia have changed the least. In addition, managers in those two countries, together with Kosovo, are the least satisfied with regulations on trade.

Notwithstanding the relatively good individual country scores, the comparison of the progress made between 2005 and 2008 shows that the SEE region has made less progress than CEB. Figure 6 indicates that on average, respondents in CEB feel that customs and trade regulations are much less of an obstacle in 2008 than in 2005, whereas entrepreneurs in SEE countries did not notice much improvement.

²³ Expressed in days, includes document preparation, custom clearance and technical control, port and terminal handling, inland transport and handling.

²⁴ Score rank from 0 to 3, with 0 representing no obstacle at all and 3 representing a major obstacle. There are no data available for Kosovo under UNSCR 1244 and Montenegro in 2005.

Figure 5. BEEPS: How much of an obstacle is custom and trade regulations?

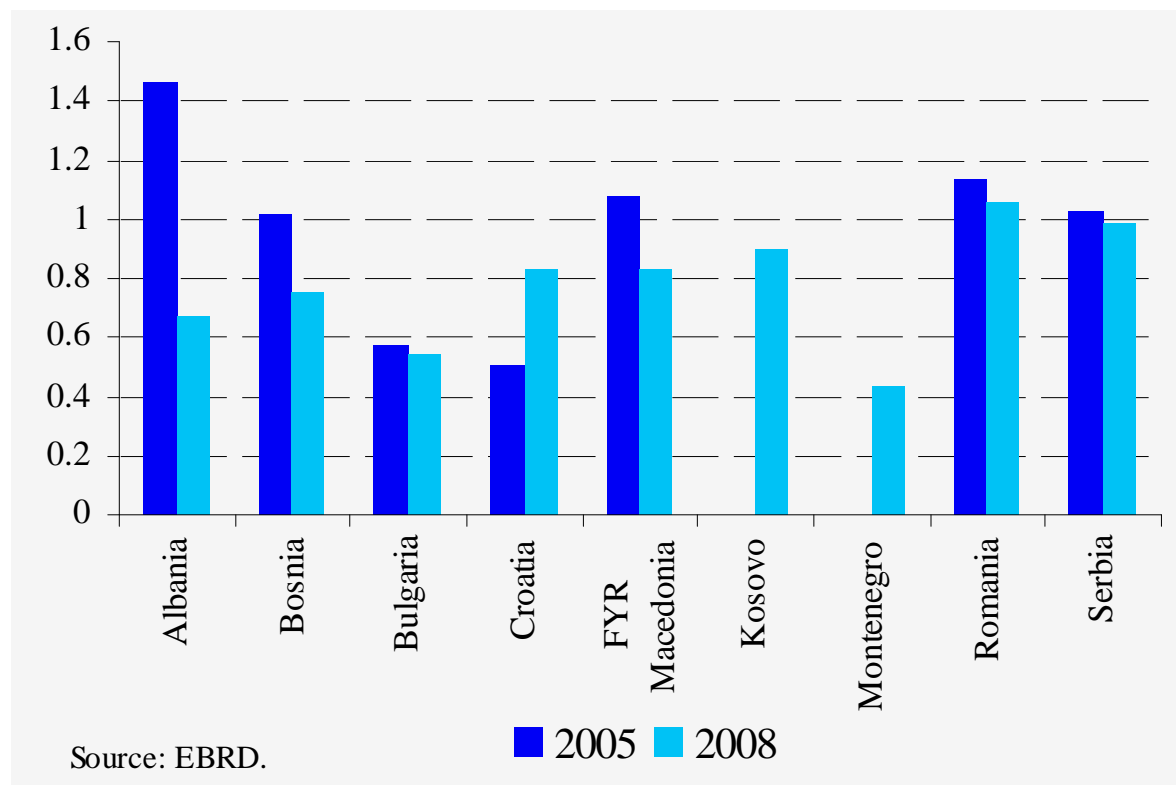
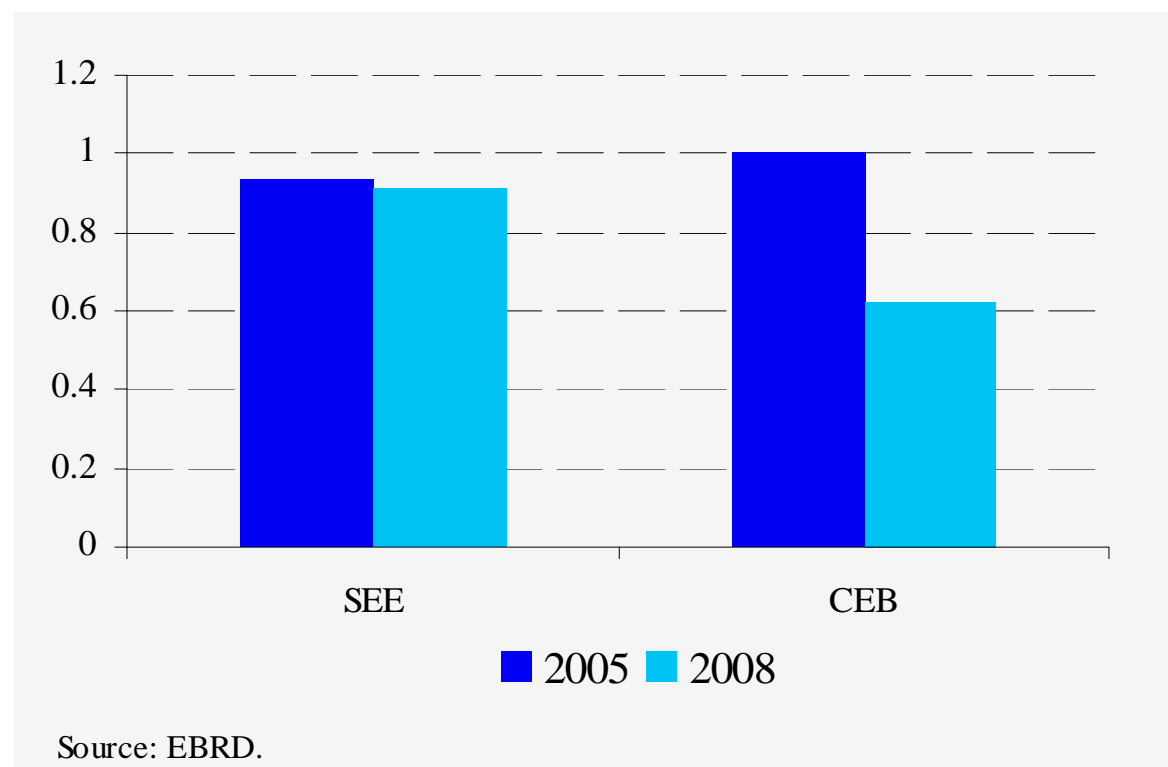


Figure 6. How much of an obstacle is customs and trade regulations? – Regional comparison



Conclusion: Measures to address

The analysis above clearly indicates that non-tariff barriers continue to negatively affect cross-border trading and impose obstacles to growth in SEE. Broadly speaking, national authorities in SEE can engage on three different levels to enhance trade integration: (i) at the multilateral level within the structure of the CEFTA 2006 agreement, (ii) at the European level and (iii) unilaterally by adopting policies to facilitate and support trade.

The CEFTA 2006 agreement offers a unique platform for governments to raise issues related to non-tariff trade barriers and to work together on overcoming the aforementioned obstacles. In addition to the measures incorporated in the CEFTA agreement, which need a clear commitment for further action, more general trade-facilitating steps such as administrative and logistic procedures should be addressed. Custom and trade regulations should be harmonised and adapted to European standards, and countries should collaborate to improve trade infrastructure. This will not only facilitate *intra*-regional trade but will help the Western Balkan countries on the road to EU accession, as well as making the region more attractive to foreign investors.

In addition, the prospect of EU integration provides an important incentive for the region to remove NTBs, both in cooperation with the EC and within CEFTA. As part of the Stabilisation and Association Agreements that almost all countries²⁵ have signed with the EU, accession candidates are required to adopt important elements of the EU's *acquis* and to comply with the EU's technical, phytosanitary and sanitary standards to trade. The present lack of compliance with these standards is the most severe impediment to expanding trade to the EU. However, significant discrepancies remain across the region and a multi-speed adoption of EU law could lead to additional barriers within SEE. It is therefore important that authorities collaborate also within the framework of CEFTA on these matters and encourage the mutual adoption of EU law.

Finally, national governments in SEE should amend domestic policies to increase trade integration. Comprehensive information for local businesses on administrative procedures required for exports and imports is a first important step. Considering the importance of Small and Medium-Sized Enterprises (SMEs) in many SEE countries, authorities should further address SME development and

²⁵ Except for Kosovo under UNSCR 1244.

support SME operations in higher added value sectors with export potential. Lastly, a crucial aspect of trade policy should be to ensure that adequate competition policies are in place to increase productivity across the economy. This will also prepare local markets to cope with competitive pressures as the EU accession process continues.

CHAPTER 4: The Greek crisis - the threat to neighbouring Balkan economies

Laza Kekic

The economic recovery in the Balkan transition economies in 2010 is expected to be weak and fragile. Average growth of about 1% is forecast for this region in 2010, following an estimated contraction of 5.2% in 2009. The pick-up in leading trade partners in the euro zone in 2010 will be modest. Credit conditions will still be generally tight and private consumption will be constrained by high unemployment. In many countries, fiscal tightening will be on the agenda, including in countries with IMF programmes. Structural problems, macroeconomic imbalances and appreciable levels of political risk suggest that there are high risks even to this subdued outlook.

Table 1: Macroeconomic balances in the Balkans

| | Budget balance, % GDP | | Public debt, % GDP | | Current account balance/GDP, % | |
|------------------------|--------------------------|-------|-----------------------|-------|-----------------------------------|-------|
| | 2008 | 2009 | 2008 | 2009 | 2008 | 2009 |
| Balkans | -1.9 | -3.9 | 29.5 | 33.3 | -14.4 | -6.0 |
| Albania | -5.3 | -6.4 | 53.6 | 55.4 | -14.9 | -15.3 |
| Bosnia and Herzegovina | -4.0 | -5.2 | 40.0 | 44.0 | -14.9 | -8.2 |
| Bulgaria | 3.0 | -0.7 | 14.1 | 15.5 | -25.2 | -8.6 |
| Croatia | -1.8 | -3.2 | 42.2 | 44.5 | -9.0 | -5.5 |
| Macedonia | -1.0 | -2.6 | 20.8 | 25.3 | -13.0 | -8.5 |
| Montenegro | 1.3 | -1.9 | 24.9 | 28.8 | -29.2 | -14.4 |
| Romania | -4.8 | -7.2 | 14.7 | 21.2 | -12.4 | -4.2 |
| Serbia | -2.2 | -4.5 | 26.0 | 31.3 | -17.8 | -5.4 |
| | | | | | | |
| Greece | -7.8 | -13.0 | 102.6 | 116.3 | -14.6 | -11.2 |

Source: National statistics, Economist Intelligence Unit. The Balkans average excludes Greece.

On top of that, there are now also concerns that the potential fallout from the Greek crisis, to which some of the Balkan economies are exposed, could plunge the region into stagnation or worse. The Greek crisis is likely to affect the region in a variety of ways, and the risks are unlikely to dissipate for some time. There is a risk of financial contagion. For some countries there will be an adverse impact on trade, foreign direct investment (FDI) and worker remittances. Above all, the crisis could spill over

through the Greek banks that are heavily involved in the region. Finally, the crisis could also affect the prospects and timing of further EU and euro enlargement.

The current situation in Greece has stabilised of course, owing to the IMF-EU loan facility that was put in place in May 2010, easing the pressures on Greek bonds for the next two years. What will happen beyond this point is still far from clear. But at present most observers expect that the Greek economy will continue to contract by 4% this year and 2.6% next year, driven by a slump in domestic demand. There is clearly a significant risk that the situation may become even worse, which would then magnify the various risks for the wider region.

Vulnerability to financial contagion

The Greek crisis increases the chances that investors will focus on the vulnerabilities in the region's economies and there is some risk of financial contagion from the crisis – in particular for Bulgaria, Serbia and Romania. There has been some increase in risk premia that can be traced to this effect. In February, the cost to protect Bulgarian debt from default rose to a five-month high and Serbian long-term yields increased the most since July 2009.

There are some similarities between Greece and the former communist Balkan economies. Widespread corruption, large informal economies and tax avoidance characterise to a greater or lesser extent all economies in the region. There are common problems with pension systems, including declining and ageing populations and low birth rates. In terms of recent economic policies, many countries pursued pro-cyclical macroeconomic policies before the crisis struck. These countries experienced a rapid expansion of consumer credit from a low base resulting in often unsustainable levels of household indebtedness. Related to this, very large current-account deficits, in excess of 10% of GDP, have been common throughout the region.

There are, however, major differences between Greece and the other Balkan countries. Some countries in the region have flexible exchange rates so can adjust more easily. Most important, although a few countries have uncomfortably high budget deficits and a few have public debt levels above 40% of GDP (the level that the IMF reckons is an acceptable threshold for emerging markets), nowhere are the fiscal problems anywhere as acute as in Greece. Average budget deficits and public debt levels are far lower. The Balkan countries have also, unlike Greece, cut their current-account deficits sharply since 2008.

Table 2: Dependence on trade with Greece, 2008

| | Exports to Greece, % of total goods exports | Total goods exports, % of GDP | Exports to Greece, % of GDP |
|------------|---|-------------------------------|-----------------------------|
| Albania | 11.6 | 8.9 | 1.0 |
| BiH | 0.4 | 19.4 | 0.1 |
| Bulgaria | 9.9 | 45.1 | 4.5 |
| Croatia | 0.3 | 20.4 | 0.1 |
| Macedonia | 12.4 | 42.1 | 5.2 |
| Montenegro | 12.3 | 15.9 | 2.0 |
| Romania | 1.8 | 24.8 | 0.4 |
| Serbia | 2.2 | 18.5 | 0.4 |

Source: National statistics, IMF, Economist Intelligence Unit

Real economy effects

The Greek economy is small compared with major euro zone economies, but it has significant links with some of the small Balkan economies. Possible channels of contagion from the real economy include trade, remittances and FDI flows within the region. For Bosnia and Herzegovina and Croatia, the trade, investment and financial links with Greece are negligible. Barring a major impact of the Greek crisis on euro zone activity as a whole, the risk of any spillover effects for these two countries are very low. Trade relations with Greece are most important for Montenegro, Macedonia, Bulgaria and Albania. Trade with Greece makes up 10-12% of total goods exports for these countries. However, given very low shares of goods exports in GDP for Albania and Montenegro, only in the cases of Bulgaria and Macedonia do exports to Greece form a significant share of GDP (4-5%). But even for those two countries, the impact through trade would shave at most a couple of decimal points off growth rates.

The Greek crisis will affect hundreds of thousands of migrant workers in the country. Albania will be the most affected, as some two thirds of migrants in Greece are from Albania. Ethnic Albanians make up at least 10% of the total Greek workforce. Many of these have lost, or will lose their jobs and the negative impact of their loss of earnings will be felt in Albania. In 2009 workers' remittances amounted to about 12% of GDP in Albania; Morgan Stanley has estimated that at least US\$900m (8% of GDP) came from Greece. After Albania, the next biggest sources of migrant workers in Greece are Bulgaria and Romania (less than 10% of total each). However, relative to their GDP, remittances play a much smaller role in these economies.

Table 3: FDI inflows, US\$ m

| | 2008 | 2009 | 2008/09, % change |
|------------------------|--------|--------|-------------------|
| Balkans | 34,638 | 18,879 | -45.5 |
| Albania | 937 | 950 | 1.4 |
| Bosnia and Herzegovina | 1,056 | 600 | -43.2 |
| Bulgaria | 8,998 | 3,870 | -57.0 |
| Croatia | 4,798 | 2,800 | -41.6 |
| Macedonia | 599 | 250 | -58.2 |
| Montenegro | 1,464 | 1,774 | 21.2 |
| Romania | 13,365 | 6,715 | -49.8 |
| Serbia | 3,423 | 1,920 | -43.9 |

Source: National statistics, Economist Intelligence Unit

Foreign direct investment (FDI) inflows were a crucial driver of growth before the crisis and they are the key to a sustained recovery. FDI inflows into the Balkans plummeted by some 45% in 2010 and it does not look like they will recover any time soon. Likely retrenchment by Greek investors reinforces the poor prognosis.

For over a decade Greece enjoyed a rising trade surplus with countries of the region, and recycled much of this surplus back into neighbouring economies through FDI into the banking sector, telecommunications, construction and the food industry. Geographic proximity and the willingness to take on risk underpinned Greek companies' investment drive.

Albania, Serbia, Bulgaria and Macedonia are the most vulnerable to negative spillover through reduced FDI flows. Greece is either the largest or second largest foreign investor in all of these countries. The stock of Greek-owned FDI accounts for 7-9% of GDP in all four. Furthermore, the penetration of Greek capital in the region is higher than official figures suggest (this is especially true for Romania) because many Greek-owned companies are registered in other countries.

There was already a considerable decline in Greek FDI flows to the region in 2009. Greek FDI flows to Bulgaria plummeted last year to only Euro48.5m (2% of all FDI inflows) from around Euro400m (7% of the total) in 2008. Greek FDI flows to Serbia amounted to some Euro46m in both 2008 and 2009, well down on the 2007 total of Euro336m. The present Greek crisis means that the chances for a recovery in Greek FDI flows to the region any time soon are very slim.

Table 4: Inward FDI stocks, 2008

| | Inward FDI stock, US\$m | Inward FDI stock, % of GDP | FDI stock, % Greek origin | Greek FDI, US\$bn | Greek FDI, % of GDP | Greek FDI, rank |
|-----------|------------------------------------|---------------------------------------|--------------------------------------|----------------------------------|--------------------------------|--------------------------------|
| Albania | 3,625 | 33.5 | 25.0 | 906 | 8.4 | 1 |
| Bulgaria | 42,525 | 107.5 | 8.3 | 3,530 | 8.9 | 2 |
| Macedonia | 3,739 | 48.8 | 15.0 | 561 | 7.3 | 1 |
| Romania | 72,608 | 42.9 | 6.5 | 4,720 | 2.8 | 6 |
| Serbia | 19,080 | 45.8 | 15.0 | 2,862 | 6.9 | 2 |
| Total | 141,577 | 43.8 | 8.9 | 12,578 | 3.9 | |

Source: National statistics, Economist Intelligence Unit

Greek banks

The most likely channel for significant contagion is through the Greek bank subsidiaries operating in the region. There is a risk that Greek banks will reduce their exposure in the region as a result of funding and liquidity pressures on the Greek parents. The risk has come at a time when the financial sector outlook for the region was already problematic, with increased NPLs and weak credit growth.

Greek banks have invested heavily in the Balkans; in 2008 Greek banks' market share in the financial sector of the Balkans was about 20%. The National Bank of Greece, EFG Eurobank, Piraeus and Alpha Bank are major players in the region. These banks' assets in the region are worth some Euro70bn. Greek banks account for four of Bulgaria's top 10 banks, three of Serbia's, and two of Romania's. They account for 15% of banking assets in Serbia and Romania, 25% in Albania and almost 30% in Bulgaria.

The Greek banks will not wish to damage their reputational credibility in the region. However, there is a risk that pressure in their home market could drive them to limit credit activity abroad; in particular, they could be forced into financing the Greek government.

The subsidiaries are to a significant extent funded with loans from Athens rather than local deposits. Even if Greek banks do not withdraw from the region, they will try to grow the local deposit base faster than loans, and they are likely to refrain from making fresh loans for a while. This risk comes on top of the already existing wider risk that the 2009 recession will lead foreign banks more generally to reduce their exposure to the region. Last year's "Vienna initiative", (in which Greek banks also participated) was associated with IMF programmes in BiH, Serbia and Romania and entailed a commitment by foreign banks to maintain their exposure to these countries. The initiative

has been formally renewed, but was in any case expected to be less effective in 2010, even in the absence of the Greek crisis.

Impact on EU and euro integration

Finally, the crisis could also affect the prospects and timing of further EU and euro enlargement. It will exacerbate the existing mood of "enlargement fatigue" in some key EU member states. Greece will now be much less able to play the role of champion for the region. For example, the Greek government had been touting its "Agenda 2014" for admission of all of the western Balkans into the EU within the next few years. Euro entry for countries such as Bulgaria and Romania is now likely to become even more difficult, with the possible introduction of new admission criteria, and will be delayed.

PART B: COUNTRY CHAPTERS

CHAPTER 5: The global crisis and its propagation to Albania

Etleva Germenji

Introduction

The global crisis that erupted in summer 2007 took a while to be felt in Albania. It was in the second half of 2008 when the IMF and the Bank of Albania (BoA) publicly warned the Albanian government that the country was not immune to the global financial developments. And indeed, in the last quarter of 2008, the first signs of the crisis showed up, the main macroeconomic indicators deteriorated and remittances from emigrants fell while, in a bank run, Albanians withdrew a substantial amount of deposits from their accounts.

This chapter highlights why and how Albania got in the swirl of the global crisis and discusses the implications of the crisis for the country's future. It is structured as follows. The next section gives a brief overview of Albania's situation by the end of 2008. Section 3 highlights the spread of the contagion. Section 4 assesses the impact of the crisis. Section 5 informs on the reaction of Albanian authorities to head off the crisis. Section 6 offers a post-crisis outlook for the country while the conclusions are drawn in section 7.

Situation at the end of 2008

Following the turbulent 1990s, Albania's economy enjoyed a relatively stable and solid performance during the 2000s. Between 2000 and the end of 2008, per capita GDP in U.S. dollar terms more than doubled, and in June of that year the country graduated from IDA lending to borrowing from the IBRD. Nonetheless, the Albanian economy is still one of the smallest and least sophisticated economies in Europe. Services constitute the largest sector, generating more than half of GDP. Agriculture is the second largest, generating almost one fifth of GDP but accounting for more than half of employment. Generating approximately one seventh of GDP, construction qualifies as the largest industrial sector.

The financial system, dominated by the banking sector, is stable and compares well within the region. Banks have focused on the domestic market having little or no direct exposure to foreign

markets. The stock market is still in its infancy. There is a well-developed primary market where the Albanian government is the only supplier of securities, and a narrow secondary market for T-bills while derivatives are almost never used by corporations.

As regards foreign trade, exports make up about 11% of GDP. The EU represents by far the main trading partner, providing more than 60% of Albania's imports and receiving almost 80% of its exports (BoA, 2009). Yet, the EU is not only the main trade partner, but also hosts over one million Albanian emigrants. The two main receiving countries are Greece and Italy, hosting 577,500 and 402,000 Albanians respectively (Eurostat, 2009) and accounting together for almost 80% of remittances. The latter amounted to almost 10% of GDP in 2008 (BoA, 2009).

Last but not least, the informal sector represents a sizeable part of the country's economy. Tax evasion is estimated at approximately 11% of the GDP and only one third of employed people are believed to be registered and pay social insurance contributions (UNDP, 2008).

Propagation of the crisis

Initially, the Albanian government argued that the country's economy was not affected by the global crisis. However, the deterioration of macroeconomic indicators in the last quarter of 2008 signalled that the effects had well and truly set in. In early 2009, the IMF, the EBRD and the BoA all revised downwards the country's growth projection for 2009 to a range of between 3 to 3.5% from 6% in 2008. They warned the government about the risk from the global crisis and advised it to cut some of the investments planned in 2009.

Official statistics published recently indicated that the projections have been more or less right. Albania posted a positive growth of 3.3% in 2009 (INSTAT, 2010), and in the statements released recently, both Albanian authorities and representatives of the international financial institutions (IFI) agreed that the Albanian economy has been sheltered from the full impact of the global crisis. Limited integration into global markets, an underdeveloped stock exchange as well as the prevalence of informal economic practices have provided an important buffer. Yet, the sheltering had been only partial – the economy has been affected due to adverse spillovers in exports, remittances and tighter domestic financial conditions.

Due to the large reliance on demand from the EU, Albania's exports could not keep pace with the trend increase of the previous five years and fell by 6.3% in annual average terms in 2009 (BoA,

2010). Remittances fell too. They amounted to €779 million in 2009, down 6.5% compared to 2008 and down 18.2% compared to 2007.

The banking system also experienced a difficult and unusual liquidity situation in 2009. Lower liquidity (mainly due to deposit withdrawal that started in October 2008 and continued through the first months of 2009) combined with higher credit risk resulting from the difficulties in the real sector of the economy led commercial banks to adopt tighter lending policies. In consequence, the annual growth of the private sector loan portfolio slowed down to 12% compared to 33% in 2008 (BoA 2010). Mortgage and consumer credit contracted too.

Impact of the crisis

The economic slowdown caused by the crisis had a significant impact on the macroeconomic stability of the economy. It led to a slowdown in the growth of budget revenues while government expenditures, because of the fiscal stimulus that the Albanian government chose to adapt in the first half of 2009, increased sharply. Consequently, the fiscal deficit, which hovered around 3% of GDP up to 2007, climbed to 7.1% by the end of 2009 (IMF, 2010). The inflows of FDI that were expected in 2009, mainly due to three privatization deals that had been negotiated in 2008, although substantial, only partially curtailed the government's borrowing needs. Therefore, in January 2009, the Ministry of Finance opened an international bid to ask for €300 million, but the tender failed due to lack of offers. Reduced investors' appetite for emerging market debts forced the Albanian government to postpone the planned debut Eurobond to 2010 and raise a €250 million three-year syndicated commercial loan. But, at 11%, the cost of borrowing was high compared to 5% interest rate that had been associated with a similar €230 million loan in 2008. Weak growth, the rapid expansion of public investments, and the large borrowing to finance the latter, pushed the debt ratio to close 60% of GDP. The widening of the current account deficit from 13.7% in 2008 to 15.7% of GDP by the end of 2009, added another weak spot in the country's macroeconomic conditions (IMF 2010).

The level of unemployment was also affected. By the end of 2009 the registered unemployment rate had increased to 13.8%, from 12.7% in 2008 (INSTAT, 2010). The construction and export oriented industries - including apparel, garment and footwear - were the hardest hit by the crisis, and shed the largest number of jobs.

The global crisis also triggered a return of emigrants to Albania. Owing to a decline in employment in Greece and Italy, a substantial number of Albanian emigrants who lost their jobs in those countries have returned home since early 2009.

Nevertheless, despite the problems created by the deteriorating conditions, the country has so far escaped civic unrest. There have however been several rallies organised by the Socialist-led opposition to protest against the alleged manipulation of the June 2009 election results by the winning right-wing coalition. And, while the country still has not managed to solve the political crisis it has faced since June 2009, the opposition has threatened to depose the government by protest if its requests are not met.

Crisis management

The government and particularly the Bank of Albania were swift to react to the crisis. In order to reassure jittery depositors the Bank, together with the Ministry of Finance and the Deposit Insurance Agency, decided to triple deposit insurance to 2,500,000 Lek (equivalent to €20,000 in early 2009). The measure proved to be an important milestone in restoring confidence in the financial system.

In addition, among several alternative fiscal rules the government chose to adopt an expenditure-based approach, not only because it was trying to anticipate an expected decrease in consumption but also in anticipation of the parliamentary elections that were to be held in June 2009. The fiscal stimulus provided an important boost to economic growth over the course of 2009.

Siding with the government's effort to foresee and cope with the difficulties created in the economy, the Bank of Albania steadily increased liquidity injection, according to the banking system's need for liquidity and the economy's demand for funding. Aiming to increase the banking sector's willingness to provide liquidity at a lower cost, the Bank cut the key interest rate twice, first in January and later on in October 2009, by 0.5 percentage points. At the same time, the Bank tightened supervisory regulations.

Last but not least, there has been also strong and continued input offered by the IFIs. In April 2009 for instance, IMF officials were sent to Tirana to discuss the problems created by the deteriorating conditions in the world economy. The institution has continued to monitor the country's economy closely and has provided valuable advice.

Post-crisis outlook

At the moment, the economic indicators show some uncertainty over the prospects for economic growth in Albania. Results from the Business and Consumer Survey, published by the Bank of Albania in February indicated that business expectations regarding the performance of both the economy in general, and their own activity, during the first quarter of 2010 were on the downside. Nonetheless, both the government and IMF officials project that this year the Albanian economy will again show positive growth. The baseline projection is for a V-shaped recovery of the economy with an annual GDP growth of 2.3% and 3.2% in 2010 and 2011 respectively (IMF, 2010). Over the medium-term, annual growth is expected to be somewhat higher but still well below the average of 6% observed over the first eight years of the last decade.

These projections were made in the beginning of 2010, while the current political crisis in the country suggests that, at least for 2010, conditions might be tougher than expected. In addition, the deep recession that is hitting Greece, Albania's second largest foreign investor and fourth largest donor, raises further concerns about the economic and political situation in the country. While there is a risk of financial contagion (the Greek banks have invested heavily in Albania), the Greek meltdown might also affect negatively the prospects and timing of Albania's joining the EU.

Conclusion

Like other countries in the region, Albania was also affected by the global crisis, but fortunately not severely. Its limited integration into global markets and especially the low level of development of financial markets has kept the country relatively isolated from the financial meltdown. In addition, the rapid response of the Albanian authorities as well as the input offered by the IFIs provided timely support. The baseline projection for the next coming five years is a V-shaped recovery. The political climate in the country and the external environment however remain questionable.

CHAPTER 6: Bosnia and Herzegovina: society and economics in the trap of politics

Anto Domazet

Introduction

The crisis in Bosnia and Herzegovina (BH) is a result of both the global economic crisis and a lack of reforms in the building of a sustainable and productive economy. It is developing into a social crisis that has increased the level of poverty and decreased the standard of living. It has also assumed the features of a political crisis, since no political decisions have been taken on the distribution of its burdens between social groups according to their economic power. Due to the loss of jobs, poor employment opportunities, reduced wages, and the uncertainty surrounding pensions and social transfers, social endurance is fast diminishing. This, in turn, increases political conflicts, threatens the fragile political stability, and makes it more difficult to reach a consensus on necessary reforms. The crisis is continuing with particularly severe consequences in the continuing growth of unemployment.

This chapter offers an analytical overview of the effects of the crisis on the social and economic situation in the country and discusses possible actions to overcome it. The discussion is focused on the effects of the global crisis that spur or restrict the implementation of political, social and economic reforms in Bosnia and Herzegovina. The emergence of the global crisis is an opportunity to prioritise the implementation of some reforms, while the vision of recovery and sustainable growth offers guidelines for the selection of priorities and possible reforms.

Political framework of the crisis

According to the 1995 Constitution, which makes up Annex 4 of the Dayton Peace Accord which ended the 1992-1995 war, the political structure of BH is based on the national division of the country. BH consists of two Entities with an ethnic majority of Serbs in Republika Srpska (RS) and Bosniaks and Croats in the Federation of Bosnia and Herzegovina (FBiH). The Entities have the fundamental authority, while the state has a weak central government in charge of macroeconomic policy, infrastructure, defence, and some other policy areas. Decisions cannot be voted in Parliament unless the majority of representatives of each constituent nation votes for them. An attempt to

reform the BH Constitution has been underway for some time already, but with no success. All the attempts at political change have been supported by the international community, which is believed to be the key factor of state functioning based on the Dayton Constitution. Over the entire post-war period, except in 2000-2002, national parties have held power. Burdened with the heritage of war, and faced with the problems of social and economic development, they cannot define a vision or reach a consensus on the central issues of the country's future. In all the decisive moments (elections, constitutional changes, police reforms, agreements with the EU or efforts to approach NATO), they have resorted to national homogenization, stirring up fears between each other and deepening divisions.

In order to maintain power national political elites desire strong states. The Serbian elite wants a strong Republika Srpska, the Bosniak elite wants a strong state of BH, while the Croatian political elite wants a third Entity. Regardless of elites' interests, there is a strong need for BH to be built as a democratic, functional, decentralized state, while the political reality will require maintaining the Entity mode of organization for a long time. Parallel to an advance toward the EU, the functions of the state and its institutions will have to be made stronger, since they guarantee economic rights, ownership rights, and collective and individual human rights for all, in every part of BH.

Political elites do not feel safe in a time of crisis. They are mired in false promises, corruption, unlawful enrichment, control over public resources, avoidance of key social, political and economic reforms, and all sorts of international confrontations. They have not gained their position without reason, as they declared themselves to be the protectors of national interests and distributed social transfers based on privileges. Instead of jobs, people have been given social allowances, creating the illusion that they are protected and economically secure. Stories about the prospects for EU accession are well received. Essentially, the political elites implement just those small reforms that are necessary for acceding to the EU, but only those which will not threaten their power.

The crisis has, however, led to the collapse of the system on which the political elites depend. Public revenues have decreased, and so too have the resources to pay for social allowances to war veterans and other welfare dependents; unemployment has increased; investments have fallen; and there are no new employment opportunities. The wealth obtained by the elite during the privatization process has lost its value. Everything that was built as a basis for their power during the growth period has collapsed during the crisis. In the time of crisis, the political elites have done their best to defend the existing system, and they expect the system to continue to function on the old

bases of political capitalism following the global recovery.²⁶ However, the crisis has put the political elites on trial. The declining economy and the conflicts which have affected the social sphere can easily destroy the existing political structure. Changes are therefore needed, and this provides an opportunity to overcome the crisis for the better.

The global economic crisis and its local reflections in Bosnia and Herzegovina

The global economic crisis hit Bosnia and Herzegovina at a delicate moment in its transition and development. On the one hand, the reforms implemented up to 2008 were not comprehensive and achieved only limited results. On the other hand, governments hesitated to implement the deeper, structural reforms needed to strengthen the economy, improve competitiveness, and restructure the public sector. All this made the economy vulnerable to the effects of the global economic crisis.

The growth model for BH in the last five years was a model based on 'catching-up' with the SEE region and the EU countries, based on a high degree of liberalization in external and internal economic relations. Trade was liberalized, especially after the signing of the CEFTA agreement in 2006, and the Stabilization and Association Agreement with EU in 2008. Foreign banks attained a dominant market position, and they became the most important channel of foreign capital inflow to the country (Landesmann 2010: 2). Although proclaimed to be export led growth, economic growth in the last five years was based mainly on a huge credit expansion which supported local consumption. It provoked a high current account deficit between 12% and 15% of GDP, and the sustainability of external financing became the dominant issue of macroeconomic policy.

In BH, the consequences of the crisis were felt mostly in the real sector, although the financial sector was not spared its blows either. The main macroeconomic indicators in 2009 and some for the first half of 2010 are presented below. In 2009, GDP fell by 2.9%, industrial production by 3.3%, exports of goods and services by 17.6%, and imports of goods and services by 24.2%. Consequently the current account deficit improved from -13.3% of GDP in 2008 to -6.6% in 2009. But this was paid for by an increase in unemployment of 49,500 persons by the end of June 2010, with registered unemployment reaching 43.1% of the active population. The budget deficit reached 5.3% of GDP in 2009 and a €1.2 billion Stand-by Arrangement with the IMF was agreed as the solution to save the public finances. Household consumption and investments were reduced by 4.1% and 30.2%

²⁶ We mention political capitalism as a coinage by Croatian professor Josip Županov, who uses this concept to define the distribution of resources and revenues not by market but rather by political criteria of belonging to a specific ruling elite.

respectively, but government consumption increased by 3.2%. Foreign direct investments fell to one half of the 2008 level.

Although exports increased in 2010 by more than 30% compared to 2009, generated by the recovery in the EU countries, there are no clear signs of recovery in BH at the end of 2010. Two main structural problems in BH are now more important than ever. The first is small-size, service-based economic structure and the low competitiveness of the real economy which, with just €3,686 GDP per capita, is in the position of a “middle income trap”. This means that the high costs of production prevent BH being a low-cost competitor, while the low innovation capacity hinders the growth of high value added exports for the EU and regional markets. The second structural problem is the unsustainable level of public consumption, which is projected to reach almost 50% of GDP (IMF, 2010, p.20). The expansion of public consumption began in 2006, with the introduction of the value-added tax which boosted tax revenues. A lack of structural reforms and public sector reforms resulted in the entire additional income being spent mainly on administration, neglecting public investment in infrastructure or improving the quality of public services in health care and education.

Economic recovery requires new policies and strategies

It is naïve to believe that the recovery in BH will be a natural continuation of the global or regional recovery, which, generally seems to be very fragile and uncertain. In aiming for recovery and sustainable growth and development BH is coping with dramatic changes in its internal and external environment. In such circumstances, there is need for new policies and new policy priorities in BH. The top priority is Constitutional reform in order to increase the efficiency and functionality of the central government in the process of European integration, in promoting economic growth and protecting human rights. This should be followed by a strong effort to initiate reforms related to the implementation of the Stabilization and Association Agreement with the EU. The short term goal is for BH to obtain candidate status for EU membership in 2011. Along with strengthening the state institutions and fighting corruption, this would greatly enhance political stability in the country and would have a positive impact on international investment in BH.

In the economic sphere there is need to improve macroeconomic stability, and especially to ensure fiscal, public debt and current account sustainability. The main goal of macroeconomic policies should be to support economic growth between 5% and 6% annually, and to increase employment based on a gross investment rate of between 22% and 25% of GDP. Privatization, public sector reforms and the improvement of the business environment should attract domestic and foreign

investors for investment in the energy sector, the Corridor Vc highway based on a public-private partnerships, as well as in the metal, wood, food, beverage and other industrial sectors and in tourism. The tradable goods sector, based on export-led growth, should be a sectoral priority based on a policy of reindustrialization in order to generate faster growth, increase employment, improve current account sustainability and set up a strong basis for different kinds of business services (ICT, financial, marketing, accounting, legal), energy efficiency services, and services of environmental management.

Thorough reforms in the political, social and economic area are needed in order to build the sustainable foundations for economic development and people's wellbeing. The global recovery can only provide an opportunity for economic recovery to gain momentum in BH if it is accompanied by internal reforms to ensure faster economic growth. BH is a country of high social values inherited from the former Yugoslavia, with good education, high standards of health and social care and social security. According to the 2009 UN Human Development Index, BH ranked 76th out of 182 countries, and is included in the category of countries with a high level of human development. However, the economic base for sustaining such a level of human development is slowly disappearing, with the crisis devaluing it even further. Consequently, in the changed, post-crisis environment, human development through education and health improvement should be prioritised, and the public sector should be restructured so that it could become more efficient using less public revenue, and developing new partnerships with the private sector.

Policies and way out of the crisis in Bosnia and Herzegovina

Overcoming the economic crisis begs the question as to how to achieve political consensus for managing the process of recovery and sustainable growth. There are three possible scenarios in BH.

The first, opportunistic, scenario starts from the view that the crisis in BH is primarily an economic crisis, due to disruptions in the global economy. The domestic contribution to the crisis is limited to excessive government expenditure and the slow implementation of privatisation. A way out of the crisis will be found by balancing the public sector at a lower level until the global recovery sets the local private sector in motion.

The second, pragmatic scenario starts from the view that although the crisis was initially prompted by the global recession, it was additionally worsened due to a weak economy, an inefficient public sector, an unfavourable business environment, a high level of corruption and the weakness of state

and market institutions. Overcoming the crisis should be focused on measures for economic revival through supply-side incentives and measures to boost consumption, as well as social sector reforms aimed at supporting socially vulnerable groups. Parallel to this, measures should be taken to implement structural and political reforms and to achieve the status of EU candidate and NATO membership. These reforms include amendments to the Constitution of BH to eliminate discrimination against minorities and to strengthen central government and its capability to lead the country towards Euro-Atlantic integration.

The third scenario of maximalist expectations starts from the view that the crisis in BH is due not only to the global economic crisis, but also to the dysfunctional constitutional and political structure based on the Dayton Accord. In this scenario, the pre-requisite for efficient crisis management lies in making changes to the Constitution that would restructure the government and strengthen central authority and decision-making in the House of Representatives of the BH Parliament without the national key, while the interests of Serbs, Bosniaks and Croats would be protected in the House of Nations. In the meantime, given the unlikely implementation of such reforms, crisis management is proceeding based on the first scenario only.

In the future, BH must develop on a democratic basis of the common interests of the nations and citizens. Its efficient functioning requires a political consensus on the country's vision and goals, the establishment of constitutional and legal regulations, and the construction of new institutions in the areas of economics, public services, the rule of law and the protection of citizens' and nations' individual and collective rights.

Conclusion

Although the crisis in BH initially appeared as a result of the global crisis, it has been additionally aggravated by internal factors which are due to poor political and economic management in the country. In the area of politics the country is divided, without a single economic space, and there is no consensus on its future. However, no matter how profound the crisis is, BH has an opportunity to accelerate recovery and achieve sustainable economic growth. The recovery requires acceleration of economic and political reforms, the stimulation of private entrepreneurship and the mobilization of development resources, the strengthening of market institutions, and ensuring the rule of law and fighting corruption.

CHAPTER 7: Facing the crisis – bitter pills for the transforming Bulgarian economy

Stoyan Totev and Grigor Sariiski

The progress of the crisis in Bulgaria - what has changed?

For most of the EU countries the crisis was felt after the mid 2007 when the capital markets crashed, including those in the countries of the Central East Europe (CEE). The Bulgarian stock exchange felt the negative influence of the crisis a few months afterwards - in late November 2007 – when the Bulgarian index SOFIX started to fall. For the next 16 months it experienced the largest losses in the region – 87 percent. These changes were conditioned mainly by the relative immaturity of the local capital market which has low liquidity, insufficient transparency, weak protection of minor shareholders and little participation by foreign investors. The latter factor in particular determined the lagged reaction to the global crisis, which Bulgaria managed to avoid for a few months.

The situation in the banking sector is different. Although most banking institutions are owned by foreign companies, most of the assets (about 80 percent) in the banking system are covered by local deposits. Higher values of the ratio of customer deposits to total bank assets are normally a characteristic of less developed financial markets. Yet in this case, financial immaturity was a factor of stability particularly in the context of ongoing funding pressures, which encouraged parent banks to reduce their external financing to their subsidiaries in Bulgaria. That is why at the same moment as the US FED began to cut interest rates from 5 percent to almost zero in order to push more liquidity into the US banking system, the Bulgarian central bank was still taking steps to cool down credit expansion– including increasing the minimum required reserves from 8 percent to 12 percent in September 2007.

The problem with diminishing capital flows has been more tangible for the real economy. New start companies have been discouraged by the restrictive credit policy of the local banks, while existing companies are closing down their activities because reduced orders are preventing them from serving their credit obligations to banks as well as to other companies. It is expected that bad debts will increase by 50 percent in 2010, which will increase the rate of bankruptcy and is one of the main challenges to future economic recovery.

There is little difference between the reduction in GDP in Bulgaria and the experience of other emerging markets in the region. When the EU economies contracted, economic growth in Bulgaria also declined. The decline in producer prices signalled that the consequences of the global crisis had started to become more noticeable for Bulgarian manufacturers. Above all, the collapse of international trade had a significant negative impact on the output of exporting companies. Exports to EU countries (about two thirds of all exports) fell by 23 percent. Such a sharp fall was far greater than had been expected. To some extent this can be explained by the fact that exports consisted mainly of products with constant returns to scale (predominantly labour intensive products), which find it difficult to compete on the free international market in normal times, let alone during a period of global economic crisis. In addition to its labour intensity, local manufacturing is also highly energy intensive. The energy consumption per unit of GDP is almost several times more than the EU average, and more than 50 percent higher than the next most energy intensive EU country. This is a serious obstacle to the international competitiveness of Bulgarian companies.

Consumer demand is also falling due to households' reduced access to credits, problems in servicing household debts, and a slump in consumer confidence. A further significant factor has been that the economic slowdown was combined with a sharp decline in the inflow of remittances from abroad. The contraction of local business has furthermore reduced the opportunity to support declining household budgets by earnings from a second job; which in any case is less common in Bulgaria than in other CEE countries. However, to be in an economic crisis is a familiar situation for Bulgarians who have survived two recent local economic disasters, in the early 1990s following the onset of transition and in the local banking crisis of 1997-1998, experiences that have helped them not to over-dramatise the situation now.

Until recently the job-losses have been concentrated in exporting sectors and in manufacturing, construction and trade. In early 2010 the unemployment rate reached almost 10 percent and was even higher (by 3-4 percentage points) if one takes into account unregistered unemployment. The influence of the global crisis on unemployment is not uniformly distributed across all population groups. It has had a greater impact on the Turkish minority, as well as on people living in small towns and villages, due to the fact that they are mainly employed in construction, which has been the most seriously affected sector. The workers in the construction sector are especially vulnerable since they are often engaged on a temporary basis, or often without a formal labour contract.

Bulgaria after the crisis – what will change?

Financial Sector

The recent macroeconomic performance has left no doubt that the Bulgarian recovery will be a slow process, for which the fixed exchange rate mandated by the currency board system can be identified as one of the main reasons. Although the currency board played a significant role as a factor of financial stability after the 1997 banking crisis, a few years later the fixed exchange rate became an obstacle to exporting local products, especially to markets where the main competitors were from countries which had been able to improve their international competitiveness through devaluation. Poland and Romania, for example, have been strong competitors to Bulgarian exporters of metal products. They devalued their currencies by 41 and 22 percent respectively, while the Bulgarian currency unit stayed anchored to the Euro, with negative consequences for the local exporters on the international markets. The situation is similar in other major export sectors such as chemicals, textile products and others. Despite its negative consequences for the economy, there are no chances of changing the fixed currency regime due to the broader aim of the Bulgarian government to enter the Eurozone.

The Bulgarian banking system is unfortunately one of the least effective in the EU. The territorial density of banking branches is almost double the average in EU countries yet *assets per employee* are only 8 percent of the EU average, making the Bulgarian banking the weakest in the EU. It is unlikely that such an ineffective structure is sustainable and the current crisis is an opportunity for making some serious changes. Most probably the efforts will be aimed at cost reduction by extending electronic banking and other measures of modernisation of the sector. This will be a difficult challenge both for banks and their customers, since the local market is still unsophisticated and unaccustomed to modern banking and financial techniques.

FDI and Exports

Structural changes can also be expected in the area of foreign investment. Up till now, the main part of foreign direct investment (FDI) was aimed at the real estate and construction sectors, as well as to banking. During 2009, the volume of FDI fell by more than 50 percent (on a year-on-year basis) mainly reflecting the high shares of FDI in real estate and finance. The construction sector will probably never regain the same degree of popularity as a sector for making highly profitable and speculative investments; and it is highly unlikely that the level of investments made in the pre-crisis years will return. For the banking sector, it will also take a long time before investment volumes recover. The long-term contraction of FDI will be a serious problem for future economic stability due to the chronic negative trade balance which will need to be financed by other means.

It will be a hard task to regain the lost export markets and to recover the reduced orders from abroad, especially in the context of a fixed exchange rate. It can be expected that this limitation along with the current reduction in the global supply of finance will stimulate some of businesses to take increased risks and innovate into activities with higher value added. It is only through such an improvement in competitiveness and in the quality of the goods supplied for exports that the economy will be able to achieve sustained growth in the future.

The Real Sector and the Labour Market

Since the production contraction has been largest in the labour intensive manufacturing branches and in construction, a full recovery of output and employment in the construction sector can hardly be expected. In the manufacture sector many activities that were delocalised are shifting to other destinations with lower labour costs (another effect of the inability to devalue the currency). On the ground of the expected increase in labour costs, the current manufacturing production structure has become inefficient and one can expect to see some serious changes in its composition in the near future.

The crisis has affected the labour market with a lag and it is affecting the skill structure of the labour force as well. This is due to the return of former unskilled emigrants that have come back in Bulgaria having lost their jobs in the host countries. Moreover, when the final limitations to Bulgarian workforce mobility in the EU are removed it is likely there will be a renewed outflow of skilled workers.

Two scenarios can be envisaged. The first is that, due to emigration, labour costs will increase, especially those of skilled workers. Together with the expected increase in labour productivity and in the efficiency of production, which is significantly lower than in the other CEE countries the crisis may catalyse the process of convergence to EU average wages. The other scenario, hopefully less likely, is that due to the emigration of skilled labour the Bulgarian economy may enter to a kind of vicious circle – with low productivity, low salaries, and an intensifying brain drain.

Impact on the Society

The social impact can be summarized in a few main points: a de-capitalization (degradation of the value of real estates and personal investments), a reduction in the share of rental incomes, a decrease of the propensity to consume, an increase in unemployment, and changes to patterns of social behaviour.

For a long time, many well-educated persons have emigrated abroad. It had a positive impact in terms of foreign remittances. Yet, due to the brain drain, the society lost the most active and capable citizens. It has been an obstacle not only to economic development, but also to providing the necessary stimulus to the reforms and changes that are needed to turn Bulgaria into a modern EU country.

At the same time the crisis has accelerated internal migration too. Sofia as the capital, as well as the other big cities, provides very many job opportunities which make them more attractive than rural areas to live. This has stimulated rural-urban migration flows which have additionally worsened the economic and social situation in the less urbanized regions and has widened regional inequality gaps.

The crisis has some sobering effects to the Bulgarian society. The revelation of the embedded practice of bribery within the former government is beginning to make the society more intolerant of corruption. One can say that Bulgaria is now taking a large step towards the creation of a “citizen society”. The crisis will influence the political culture of the country as well. The socialist party that was long popular, especially among the aged population, is now recognized as a party of corruption that has twice led the country into to severe crises. The left political arena in Bulgaria now needs a new face; this will stimulate the socialist party to transform itself into a real social-democratic party.

Summary

Economic recovery in Bulgaria can be expected to be a slow and arduous process. In the first place, the foreign investments that have up until recently contributed greatly to economic growth will not be available to anything like the same extent in the coming years. The recovery process will also depend on the fluctuations in energy prices. Last but not least, the extensive outflow of skilled labour force and well-educated people will continue to create serious obstacles to growth.

Nevertheless, the global crisis may have a specific healing effect on the Bulgarian economy and society. In the first place, the crisis will speed up the restructuring of production and trade, which will reduce the exposure of the Bulgarian economy to external shocks.

The crisis has forced the new government, as well as the entrepreneurs, to understand the importance of improved absorption of EU funds. Up to now Bulgaria has been an example of a country which has inexplicably neglected the opportunities provided by the EU structural funds. A

partial explanation can be found in the unwillingness of certain economic circles related to corruption; these circles would like to maintain their powerful economic position which is protected from genuine competition. They find support from some politicians that are happy to keep the Bulgarian economy in a weak condition, so that it can remain dependent for energy supplies on Russia, and hence also in a situation of political dependence of Russia.

By releasing the EU structural funds that were stopped due to the practice of corruption, Bulgaria will be able to realise many different projects supporting economic development. That will also help the government to reduce the expected increase of unemployment.

All these changes will be difficult and time consuming; however one can expect that the crisis will have a certain impact in increasing future labour productivity and energy efficiency. It will help the country to benefit from a real improvement in the sustainable competitive advantage. Finally one can maintain that the crisis has finally catalysed a break with all the remaining residues of the former communist parties, and their influence in the economy in society and in political culture.

CHAPTER 8: The crisis in South East Europe – the case of Croatia

Katarina Ott

This article tells an unhappy tale about one of nine very unlucky countries. Even though the people are charming and clever, their lives are filled with misery and woe. From the very first paragraph of this article, in which the country receives terrible news, continuing on through the entire story, disaster lurks at her heels. One might say she is a magnet for misfortune. (Lemony Snicket, adapted to circumstances)

Impact of the crisis

The South Eastern European countries (SEECs) were hit hard by the crisis. The growth of real GDP turned negative in 2009 after five years of strong growth that averaged 6.5% per annum from 2004-08. General government balances deteriorated and government expenditure was higher than in other transition countries. However, thanks to contractions of imports caused by falling economic activities, the usually high current account (CA) deficits shrank in all SEECs in 2009. Croatia was no exception, as real GDP fell by 5.4%, the government deficit reached 3.3% of GDP and the current account deficit reached 8.5% of GDP.

Table 1: Impact of the global crisis (% of GDP)

| | Year | SEECs average* | Transition countries average** | Worst among SEECs | Best among SEECs | Croatia |
|----------------|------|----------------|--------------------------------|-----------------------|--------------------|---------|
| GDP growth | 2009 | -6.2 | -6.2 | -8.0 (Romania) | +3.0 (Albania) | -5.4 |
| GG balance | 2009 | -4.0 | -4.2 | -7.3 (Romania) | -0.1 (Bulgaria) | -3.3 |
| GG expenditure | 2008 | 38.1 | 36.8 | 47.9 (B&H) | 27.4 (Albania) | 39.4 |
| CA balance | 2009 | -12.9 | -4.9 | -22.8 (Montenegro) | -6.0 (Romania) | -8.5 |

Source: EBRD (2008, 2009).

*SEECs include Albania, Bosnia and Herzegovina, Croatia, Bulgaria, Macedonia, Montenegro, Romania and Serbia.

**28 transition countries covered by EBRD (2009) and 29 covered by EBRD (2008).

The overall situation in Croatia is not much different from the situation in other SEECS – decreasing GDP, increasing general government deficit, decreasing current account deficit and high general government expenditure. The regional average FDI of US\$ 27.8 billion in 2007 and 2008 almost halved to US\$ 14.3 billion in 2009. Comparable data on public and external debt are unfortunately not yet available; however, the estimates for Croatia show an increase in the national budget deficit from 2.3 billion Kuna in 2008 to 9.3 billion Kuna in 2009, financed through borrowing (Ott et al., 2009) resulting in public debt of the broadly defined public sector above 50% GDP at the beginning of 2010 (Šonje, 2010).

It was not rosy even before the crisis

While some indicators such as economic growth and FDI were strongly affected by the crisis, Croatia had long been confronted with problems that should have been tackled sooner. The country had been living recklessly above its means for too long, and now in the crisis it will have to pay expensive international and domestic bills.

Table 2: Situation before the global crisis (% of GDP)

| | Year | SEECs average* | Transition countries average** | Worst among SEECs | Best among SEECs | Croatia |
|--------------------------------|------|----------------|--------------------------------|--------------------|-------------------|---------|
| Current account balance | 2008 | -18.7 | -7.6 | -33.6 (Montenegro) | -12.3 (Romania) | -9.4 |
| General government expenditure | 2007 | 38.1 | 35.5 | 47.4 (B&H) | 25.7 (Albania) | 40.3 |
| General government balance | 2008 | -1.8 | -0.2 | -5.7 (Albania) | 3.0 (Bulgaria) | -1.4 |
| Public debt | 2008 | 31.0 | - | 54.0 (Albania) | 14.0 (Bulgaria) | - |
| External debt | 2007 | 42.0 | - | 105.0 (Bulgaria) | 18.0 (Montenegro) | 89.0 |

Source: EBRD (2008, 2009).

*SEECs include Albania, Bosnia and Herzegovina, Croatia, Bulgaria, Macedonia, Montenegro, Romania and Serbia.

**28 transition countries covered by EBRD (2009) and 29 covered by EBRD (2008).

It was not only in 2008 that Croatia had a current account deficit; indeed, this had been the case over the previous ten years and probably even longer. With high general government expenditures and budgetary deficits, it is not strange that it also had high public and external debts.

A similar picture holds for the other SEECS. During the 2001-07 period the regional average GDP growth was 5.7%, while the general government share of GDP across the region decreased by less than one percentage point. The share of general government in GDP even increased – by 5 percentage points in Montenegro and by 4.4 percentage points in Serbia. Although there are exceptions – the general government share in Macedonia decreased by 6 percentage points – most SEECS avoided fiscal consolidation and failed to decrease public expenditures or carry out necessary institutional reforms (Mihaljek, 2009; Ott, 2009).

Poor competitiveness

As a consequence of these failures, instead of being able to use a fiscal stimulus to counteract the effects of the crisis, Croatia should have cut its budget and current account deficits and accumulated funds to repay its debts. The constant current account deficits and poor scores in the EBRD ‘competition policy’ transition indicator point to a serious lack of competitiveness. The situation in Croatia can be compared to other SEECS. Using the EBRD (2009) indicators – scale of 1 to 4-plus – Bulgaria, Croatia and Romania score around 3, while Albania, Bosnia and Herzegovina, Macedonia, Montenegro and Serbia score around 2.²⁷ Moreover, all score poorly in the ‘governance and enterprise restructuring’ indicator (Croatia alone scores 3, while the others score from 2 to 3-minus).

Economic problems in Croatia are related to various institutional and administrative weaknesses. Quite often adjustments to the market are just normative; superficial reforms are made without real contents; new laws are passed without care for implementation and enforcement; laws are poorly harmonized and deficient, causing problems in the courts, while bureaucracy, corruption and organized crime flourish; and for years there was neither long-term strategy nor effective coordination (more in Ott, 2003; 2004; 2005; 2006). However, in April 2010, after being constantly blamed for not reacting to the crisis, government suddenly announced its Economic Recovery Programme. It incorporates some excellent goals: the state’s withdrawal from the economy, the implementation of necessary structural reforms, public administration rationalisation and efficiency improvement, budget expenditure reduction, tax system simplification, state aid system reform and even a fiscal responsibility law. The Programme was soon followed by the Plan for the Enforcement of the Programme.²⁸ Fulfilment of the set goals might lead to higher economic growth, a better fiscal

²⁷ The EBRD transition indicators range from little or no progress in the transition (indicator 1) to standards equivalent to those of a hypothetical advanced market economy (indicator 4-plus).

²⁸ Both the Programme and the Plan are – only in Croatian - available at <http://www.vlada.hr/>.

position and higher competitiveness. The problems with the implementation of the Programme will be elaborated later in this text.

Democratic deficit

To make substantial changes strong pressures are necessary both within the country and from the international community. However, Croatia is faced with a democratic deficit, i.e. it lacks democratic accountability and effective control over the decision-making process.

International indicators like freedom of the press, economic freedom and perceptions of corruption might be used to demonstrate the existence of the democratic deficit, but here the EU Barometer will be taken, which covers EU members and candidates, including Croatia.

Table 3: Comparison of views in Croatia and EU-27 (% of respondents)

| | Croatia | EU-27 |
|--|---------|-------|
| Distrusting political parties | 92 | 79 |
| Distrusting the government | 84 | 65 |
| Distrusting the parliament | 84 | 63 |
| Unsatisfied with the way democracy works in the country | 84 | 45 |
| Mistrusting the justice system | 80 | 52 |
| State meddling too much in their lives | 77 | 61 |
| Distrusting regional and local authorities | 71 | 43 |
| Government is best suited to deal with the consequences of the financial and global crisis | 32 | 19 |

Source: European Commission (2009a, 2009b).

Although distrust and dissatisfaction with the political system are much higher in Croatia than in the EU-27, so are expectations that the government is capable of dealing with the consequences of the financial and global crisis.

Is Croatia really ready for real reforms?

The existence of a democratic deficit implies a need for strategies and reforms capable of contributing to building efficient institutions, and improving the respect for laws and individual rights. The future might bring two possible scenarios – the first is derived from the views expressed

by Croatian respondents to the EU Barometer and the second is developed in accordance with the irrational voter theory.

Table 4: Comparison of views in Croatia and EU-27 (% of respondents)

| | Croatia | EU-27 |
|--|---------|-------|
| Expecting worse situation in the next 12 months | 57 | 31 |
| Expecting better times to come | 11 | 28 |
| Things in the country are going in the wrong direction | 71 | 30 |
| The impact of the crisis on jobs has reached its peak | 27 | 38 |
| Main concerns facing the country | | |
| Crime | 59 | 19 |
| Unemployment | 50 | 51 |
| Economic situation | 45 | 40 |
| Main personal issues faced | | |
| Crime | 6 | 8 |
| Inflation | 52 | 38 |
| Economic situation | 35 | 26 |
| Unemployment | 23 | 20 |
| Pensions | 21 | 15 |

Source: European Commission (2009c).

The findings of the Eurobarometer survey demonstrate that Croats are not only more pessimistic than citizens of other countries in the EU-27, but also that in the autumn of 2009 the number of those expecting the situation to worsen in the subsequent twelve months had increased by 6 percentage points since the equivalent springtime survey, while in the EU-27 it had decreased by 3 percentage points. Similarly, the number of those expecting better times to come decreased by 3 percentage points in Croatia, while in the EU-27 it increased by 3 percentage points.

The fear of crime in Croatia increased by 21 percentage points in just six months, while fears of unemployment and the economic situation actually decreased in the same period (by 2 and 4 percentage points respectively). That is rather strange as the majority of the same respondents said that the impact of the crisis on jobs has not yet reached its peak. Increased concerns about crime might be the consequence of strong EU pressures regarding crime in Croatia and investigations revealing widespread criminal activities among senior public officials.

While Croats are extremely worried about crime generally, it does not bother them personally. The personal fear of crime is at the same level as in the spring survey. This discrepancy in views of the effects of crime upon them personally and upon the country might mean that crime is perceived as something happening somewhere above ordinary citizens, in some high places. The highest personal concerns about inflation, the economic situation, unemployment and pensions are in line with the view that the crisis has not yet been overcome.

However, Croats seem to support reforms: 76% think that Croatia needs transformation to be able to confront the future, 67% are willing to make sacrifices for the benefit of future generations and 56% believe that the crisis makes transformations easier.

On the other hand, in a time of decreasing GDP, public sector trade unions demand increased salaries, pensioners call for higher pensions, patients resent even the smallest participation in covering the costs of health services, university students expect free education irrespective of performance, and parents insist on free textbooks for their children irrespective of their income. The list of irrational demands is endless, and bears out the claim by Caplan (2008) that voters are biased towards irrational policies, and that politicians are rational in trying to satisfy the voters and accordingly in the long run harm voters' wellbeing. Voters usually wish for markets that are less free and for more government intervention, not understanding that a successful private sector brings benefits to the public sector; voters are against liberalization of domestic markets, not understanding the benefits from participation in a more open market environment; voters wish to maintain employment at any cost, not realising that only the performance of the workers counts, and not the sheer maintenance of employment. Judging by the extent of the general government expenditures and deficits and the resulting public debt, the irrational voter theory seems to be functioning in the Croatian practice.

Ready or not Croatia needs immediate fiscal retrenchment and long run institutional reforms

In order to achieve higher competitiveness, an improved global position and higher wellbeing for its citizens, the Croatian government should insist on the set Programme and carry out long-term institutional reforms. The crisis is an ideal moment for new strategies and reforms, as the government could use the adverse circumstances to motivate society to accept unpalatable changes. Both the society and the economy have to be ready to accept and to realize the goals of the

Programme. Readiness for serious and deep reforms – liberalization and the demise of state economic interference – will be crucial. Reforms are always painful and it is now obvious, for example, that public sector employees – protected and privileged in relation to those employed in the private sector – are bent on resisting changes. They are not ready to accept changes that might benefit the young and the unemployed.

What we need is the readiness of all citizens to take the medicine – trade unions, employers, pensioners, patients. Citizens, relatively lucky to be living in a democracy, hard-won and frail though it may be, should support the changes. Politicians should be brave enough to face the risk of losing at the next elections. Without a new role for government, shifting from vertical to horizontal state aid, without education, modern technologies and entrepreneurship in the times of globalisation and the liberalisation of markets, Croatia will not be able to cope with more competitive countries.

And what is happening? First, the goal of the gradual reduction of the share of general government expenditure in GDP by 3 percentage points by 2020 is not ambitious enough, since Croatia's general government budget (at 50% of GDP) is closer to the levels of more developed countries than to the average of transition countries (at 33% of GDP) with which Croatia should compare itself. Second, some of the crucial activities set out in the Programme are already seriously behind schedule, such as the urgent improvement of liquidity within the country by the payment of all due government obligations by June 2010. Third, the government gives up its own plans whenever some interest group protests loudly enough. For example, upon announcement of the government's intention to abolish collective agreements with trade unions, these bodies started collecting signatures for a national referendum on the issue. It seems at the moment that the trade unions will collect a substantial number of signatures, since the population perceives this referendum as a vote for or against the government. The latest news is that the government has signed an annex to the collective agreement with the trade union of government employees promising them various benefits and guaranteeing not to cancel the collective agreement unilaterally. This means that agreement will oblige the government to make payments of various benefits for another two years.

The Croatian government should secure the preconditions for economic growth and fiscal consolidation. The country needs economic growth to decrease the public debt burden, increase budget revenues and enable the decrease of the deficit. It also needs fiscal retrenchment, which will be more successful and better enhance economic growth if it relies on a decrease in government spending instead of increased taxation, on cutting public sector salaries and social benefits and not

investment, on taxing consumption and not income. The country also needs a more efficient judiciary, a determined fight against corruption, and public sector transparency, in brief, a real de-politicization of the public sector.

Unfortunately, as shown above, public sector users are able to blackmail weak coalition governments. High social benefits and public sector salaries amounting to 70% of budgetary expenditures are the result of the long term pressures exerted by trade unions, pensioners, war veterans and other users. The government should break these vicious circles – carrying out reforms in the public sector, pension and health system – because ever more new borrowings to cover ever growing expenditures show no responsibility towards the new and shrinking generations of taxpayers. Instead of sticking to its Plan and drastically cutting public expenditures, which might help to establish the trust of the market and higher economic growth, the government condemns the country to stagnation supported with constant new borrowing, only transferring the consequences of irresponsible fiscal behaviour to future generations.

The way out of the crisis: the EU option and sticking to the Economic Recovery Programme

As shown in table 5 the EU Barometer's results for Croatia might lead to worrying conclusions.²⁹ However, like EU-27 respondents, Croats highly value security, solidarity, free trade and flexibility (85, 84, 80 and 74%, respectively). Croats also gave strong support to the euro and showed a higher trust in European than domestic institutions. In the midst of the crisis – despite the problems with the Slovenian blockade of Croatia's negotiations with EU because of some unresolved border issues (which now seem resolved) and the EU's accusations that Croatia does not cooperate adequately with the International Court in Hague regarding war crimes – the country strives to satisfy EU requirements. Furthermore, in the presidential elections at the beginning of 2010 voters did not elect a populist presidential candidate connected with corruption scandals (Milan Bandić, current mayor of Zagreb), but Ivo Josipović, a diffident university professor and classical music composer with no previous political exposure.

As a small country bordering with the EU, Croatia has no other option than to join the Union. Despite all its deficiencies the EU offers values Croatia should share and follow; it could help in developing an institutional framework capable of improving the cultural, historical and political patterns; it could

²⁹ Interestingly, in contrast to the Croatian results, 66% of respondents in Macedonia think that EU membership would be a good thing for their country (European Commission, 2009d).

enable an environment conducive to investment, and in the long run it could improve political stability.

Table 5: Comparison of views in Croatia and EU-27

| | Croatia | EU-27 |
|---|---------|-------|
| The country benefits by being a EU member | 36 | 57 |
| The country does not benefit by being a EU member | 52 | 31 |
| EU membership is a good thing | 24 | 53 |
| Insistence on social equality and solidarity is most important for facing global challenges | 56 | 45 |

Source: European Commission (2009a, 2009b).

The success of Croatia's response to the economic crisis will depend on the readiness of its citizens and politicians to persevere in the implementation of the Economic Recovery Programme and in fulfilling the requirements of the EU, but for both issues, leadership will be crucial. The leaders will have to be firm, ready to resist compromises and tell citizens that the reform cannot be pleasant but might bring benefits. The leaders should confront the fact that they cannot be popular and that they will be disliked by everybody – family, friends and party comrades (Harberger, 1988).

No one can guarantee success, but the crisis could and should be used to change the old and unsuccessful patterns of society. The Programme is finally a step in the right direction, but only with its proper implementation – particularly to bring about responsible fiscal behaviour – it could result in balanced revenues and expenditures, a lower budget deficit and public debt. That could then lead to higher economic growth, political stability and well being of citizens, although only over the long term. Unfortunately, there are no short-cuts in achieving these goals.

CHAPTER 9: The global economic crisis and Kosovo

Petrit Gashi

Introduction and background

Transition countries have been hit hard by the global financial crisis. The effects of the crisis on the transition economies have been compared with the effects of the transformational recession that former communist countries endured in the early nineties (Åslund, 2009). The countries of the Western Balkans have not been spared by the global crisis, although the effects were fairly uneven. Analyses by the EC (2009) and EBRD (2009) argue that this uneven pattern of effects can be explained by the degree of financial and economic integration of the Western Balkan countries into the world economy. According to these studies, the greater the integration the more severe was the impact.

However, the documents also warn that the less integrated countries will not remain immune to the crisis because of the considerable external imbalances that these countries have been facing in recent years. I generally take the same approach in this note as in the abovementioned documents. Kosovo falls in the latter group of countries. However, up to now, as the discussion shows, the socio-economic and political impact of the crisis has been fairly limited in the case of Kosovo.

Table 1: Main macroeconomic indicators

| | 2007 | 2008 | 2009 |
|--------------------------------------|-------|-------|-------|
| <i>GDP (in €m)</i> | 3,464 | 3,724 | 3,792 |
| <i>Real GDP growth (%)</i> | 5.0 | 5.4 | 3.8 |
| <i>GDP per capita (in €)</i> | 1,629 | 1,726 | 1,731 |
| <i>Current account (in % of GDP)</i> | -9.6 | -16.1 | -17.0 |
| <i>FDI (in €m)</i> | 440.7 | 366.5 | 291.5 |
| <i>Remittances (in €m)</i> | 515.6 | 535.4 | 505.6 |

Source: Central Bank of Kosovo (2010)

Note: Due to the poor quality of data in Kosovo, the indicators should be treated with caution (the exception being, financial and external sector data).

Although the effects of the crisis on Kosovo remain limited, Kosovars are wary of their uncertain economic future. Generally, the economic difficulties of Kosovo have not been due to the global

crisis, although the effects of the latter are expected to exacerbate the situation. Indeed, there are strong grounds for the disillusionment of Kosovars. First, macroeconomic indicators do not show encouraging signs: GDP growth is moderate, and Kosovo has the lowest GDP per capita in Europe (Table 1).³⁰ The high unemployment rate, estimated at over 40 percent, is chronic and persistent. On the other hand, there is a huge negative trade balance which reached 42 percent of GDP in 2008, posing a major challenge for policymakers. Kosovo still relies heavily on the foreign assistance and remittances. Moreover, Kosovo remains unattractive for foreign investors, especially since the major privatisation deals have been concluded.

Secondly, the political situation remains shaky; apart from internal political instability, the partial resolution of the political status prevents Kosovo from becoming part of, or utilizing fully the benefits of its membership in important regional initiatives (such as CEFTA for instance)³¹ and gaining access to some major international organisations.³² Even the EU accession road remains unclear; although in January 2010 Kosovo initiated negotiations with the EU in the context of the Stabilisation and Association Process several members of the Union have not recognised Kosovo's independence.³³ Thirdly and finally, there are indications of a possible social outburst. With a very high rate of unemployment and widespread poverty, the social situation may easily erupt. Bearing in mind all these facts, Kosovars have been ironically commenting on the global financial crisis: can it make things any worse!?

In this note, I discuss briefly, in a rather descriptive fashion, the impact of the crisis on the economy of Kosovo, specifically focusing on the transmission mechanisms of the crisis. Initially, I briefly review the impact of the crisis on the financial sector. Next, the discussion concentrates on the impact the crisis has had on the external sector. Further, the impact of the crisis on FDI inflows in Kosovo is briefly discussed. Remittances follow. The note concludes with a summary.

³⁰ The rate of growth in Kosovo is enviable to many transition countries, many of whom have accounted double digit negative growth rates. The growth in 2009 can be attributed to the public expenditures on the road infrastructure.

³¹ After the Declaration of Independence in February 2008 Serbia has blocked Kosovar exports, whereby they do not recognise the Republic of Kosovo stamps. In the same vein, Bosnia has been charging Kosovar products full tax charges as they have not been recognising the origin of goods of Kosovar produces.

³² In 2009 Kosovo has become a member of the World Bank and IMF. There are plans for embarking on WTO accession process. In addition, Kosovar institutions are eyeing membership in EBRD and some other international institutions, which will pave the way for developing some major economic projects in Kosovo.

³³ Instead of the SAP, the EU designed for Kosovo a negotiation tool called Stabilisation Tracking Mechanism which has been operational since 2003. At the beginning of 2010, the EU has converted the former into a SAP 'dialogue' for Kosovo. The need for all this manoeuvring emerged as the EU members were divided on the issue of political status of Kosovo.

Global crisis and the banking sector

The banking sector in Kosovo has been operating on sound grounds, and has been hailed as one of the bright spots in Kosovo's economic landscape. There has been a steady improvement in the financial development of Kosovo, as indicated by the credit-to-GDP ratio (see Table 2). The Central Bank of Kosovo (2010) reported a strong performance of the banking sector even in 2008 and 2009, despite the global crisis. According to the report, bank assets have risen sharply. The average growth of bank assets was 25 percent from 2006 to 2009. Both loans and deposits have increased constantly since early 2000. The banking sector is rather liquid as the loan-to-deposit ratio shows. In recent years, the growth in deposits was well over 20 percent. A similar pattern can be noted in respect of credit growth, albeit with a significant drop in 2009 which has been the only visible sign of the impact of the global crisis in the banking sector of Kosovo. Such a cautious approach to credit creation can be expected in a time of crisis. Still, the overwhelming share of credit is channelled to the private enterprise sector, although with a small slide in 2009. The lower growth rate of credit seems to have been reflected in a drop in the growth of credit to the private sector also. Moreover, the level of non-performing loans is rather insignificant, and shows no particular pattern of change in recent years.

Table 2: Main banking sector indicators (in %)

| | 2007 | 2008 | 2009 |
|---|------|------|------|
| <i>Growth of deposits</i> | 23.7 | 26.3 | 20.8 |
| <i>Credit growth</i> | 40.1 | 32.7 | 8.9 |
| <i>Loan-to-deposit ratio</i> | 78.0 | 81.9 | 73.9 |
| <i>Credit-to-GDP ratio</i> | 25.8 | 31.8 | 34.0 |
| <i>Credit to private sector</i> | 77.5 | 76.2 | 73.1 |
| <i>Financial integration^{a)}</i> | 51.6 | 49.9 | 60.1 |
| <i>Foreign ownership in total banking</i> | 75.7 | 92.6 | 91.6 |
| <i>Non-performing loans</i> | 4.1 | 3.3 | 4.3 |

Source: Central Bank of Kosovo (2010)

Note: a) External assets + external liabilities/GDP

In addition, there are some other features of the banking sector that are worth mentioning. *First*, one of the important drawbacks of the banking sector in Kosovo is its high level of concentration. Within the sector, only eight banks are operational, and around 80 percent of the assets are managed by three major banks. The high level of concentration and the lack of competition, *inter*

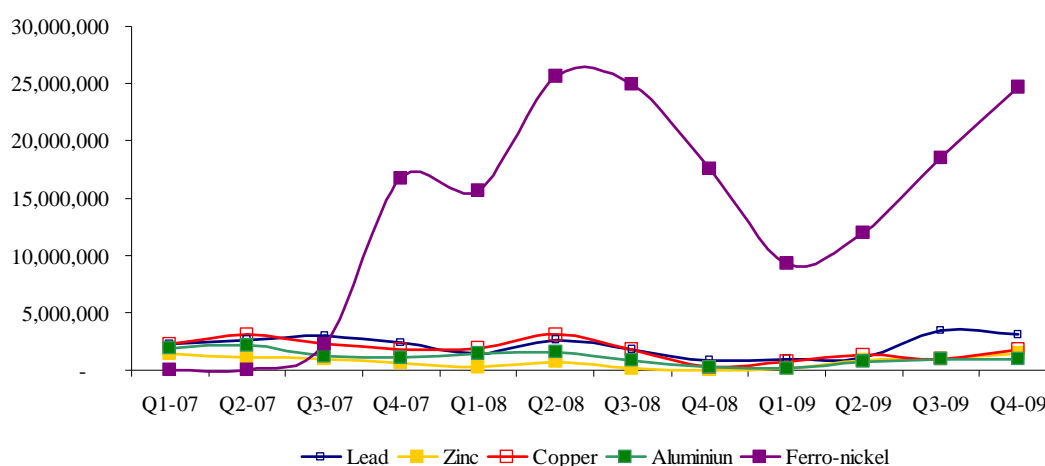
alia, have pushed interest rates to uncompetitive levels. *Secondly*, the sector is almost 100 percent foreign owned. A similar trend has been noted in the other countries of South East Europe (SEE) (EBRD, 2009). It is generally acknowledged that foreign bank ownership provides stability to the sector, and in a time of economic crisis cushions its effects (Berglof et al., 2009; EBRD, 2009). *Finally*, the ratio of bank assets and liabilities to GDP (an indicator of financial integration) is very low compared to the SEE average, an advantage for Kosovo in this time of economic crisis. One should note that the high level of financial integration has been a powerful driver of growth in the post-communist countries. However, at the same time it has made these countries vulnerable to the macroeconomic and financial instabilities that came with the global crisis (EBRD, 2009). The financial integration of Kosovo in recent years compares to the average level of financial integration in SEE in the mid-nineties. By 2007, the average level of financial integration for these countries was almost three times higher than the level observed in Kosovo (EBRD, 2009).

Global crisis and the external sector

Kosovo is an open economy. Trade openness in recent years exceeds 55 percent, a level far below the average of the SEE countries, which is almost double of the Kosovar level (see EBRD, 2009). The low level of openness relative to its neighbours reflects the low level of exporting activity. Primarily due to her underdeveloped manufacturing sector, Kosovo relies heavily on imported goods. The share of imports to GDP exceeded 50 percent in both 2008 and 2009. Exports are very low, covering just 10.3 percent and 8.6 percent of imports in 2008 and 2009, respectively. The highest level of exports in post-war Kosovo was achieved in 2008, reaching almost €200 million in value. However, in 2009 there was a significant drop in exports of around 40 percent, notably in commodity exports.

Essentially, Kosovo is a commodity exporter - in 2008 and 2009 exports of lead, zinc, aluminium, copper and ferronickel accounted for over 50 percent of total exports. These exports have fallen as a result of the crisis. As the world demand for mineral products plummeted in mid-2008, so Kosovo's exports of these commodities fell. This can be noted especially in the case of ferronickel, which has been the major commodity export in the last three years (see Figure 1 below).

Figure 1. Commodity exports of Kosovo (2007-2009, mil €)



Source: Statistical Office of Kosovo (2010)

The trend of sales of ferronickel is associated with falling prices in the third quarter of 2008³⁴ and a demand contraction in the fourth quarter of the same year. More precisely, July 2008 marked a significant drop in the sales of ferronickel, and sales did not pick up again until the second quarter of 2009. A similar picture can be drawn for other groups of commodities, although the shifts are less visible. In the third quarter of 2008 exports of these commodities fell by over 40 percent relative to the second quarter. The subsequent drop was even higher, at over 70 percent. Similar to ferronickel, exports of other commodities began to pick up again during the second quarter of 2009. All these developments appear to have been one-off events. The ferronickel and other commodity producers report that business has been returning to normal since early 2010. With prices stabilizing, the commodity producers have been increasing their capacity to meet the growing demand from world markets.³⁵

Foreign capital inflow and the impact of the crisis

Foreign capital inflow has been one of the key determinants of the revival of the post-communist countries. On the basis of this experience, policymakers in Kosovo believed that FDI would help the shattered economy emerge from the long years of inactivity, looting, and destruction in the 1990s, to recover and even to excel. Unfortunately this optimistic scenario was not fulfilled, especially in the first few years after the war. The highest level of FDI was achieved in 2007, when it reached over

³⁴ See London Metal Exchange https://secure.lme.com/Data/community/Dataprices_pricegraphs.aspx (accessed on February 20, 2010).

³⁵ See news articles "Ngritja e çmimeve ua kthen 'buzëqeshjen' gjigantëve metalurgjikë", *Koha Ditore*, January 20, 2010, p. 36; and, "Këndellen 'Trepça' dhe 'Ferronikeli'", *Zëri*, February 2, 2010, p. 7.

12 percent of GDP (see Table 1). Afterwards, one can see a significant drop of foreign investments, with falls of over 16 percent in 2008 and 20 percent in 2009.

There are various reasons for the comparatively low level of FDI including political and economic instability, the lack of feasible opportunities, the low skills of the workforce and corruption, among others. The global crisis is to some extent an additional explanation, especially regarding the fall in the last two years, although the link is really only rather marginal. Although there are no data or analysis to confirm this, it is reasonable to assume that the effects of the crisis on investors, such as the impact on investors' confidence, a fall in access to financial resources, and the low growth prospects, should explain a share of the drop in total FDI in the last two years.³⁶ However, FDI in Kosovo in previous years has been mainly associated with the privatisation process. Therefore, since the privatisation of the Socially Owned Enterprises was mostly concluded in 2007, the subsequent prospects for FDI inflows in the following years were highly circumscribed.

Remittances and the global crisis

The Diaspora has been crucial to the Kosovar economy and the welfare of its citizens, both as a remitter and investor. Recent research has shown that the majority of remittances are spent on fulfilling basic needs, such as basic consumption, clothing, and shelter.³⁷ Based on results of a household survey, the Riinvest Institute (2007) has found that over 65 percent of remittances have been spent on these three basic categories. In addition, the share of investments in remittance expenditure is quite insignificant, accounting for only 3 percent of total remittance flows. However, following the discussion in the previous section, there are indications that the Diaspora has been fairly active in the privatisation of social (state-owned) capital. Although there are no official data on the deals concluded, Diaspora investments can be singled out in the food industry, vine production, construction, fishery, wood processing, and other industries.

The numbers show that remittances account for around 14 percent of GDP in the last three years, placing Kosovo amongst the top receivers in the ex-communist block and even more widely.³⁸ As Table 1 shows, a steady stream of over €500 million per annum has flown into the country in the last

³⁶ UNCTAD (2009) summarizes the crisis effects on the international investments through, *first*, the reduced capability of firms to invest, resulting from a lower availability and higher cost of finance; *second*, the lower propensity to invest as a result of lower economic growth prospects, especially in developing countries; and, *finally*, the high level of risk perception, which is leading companies to carefully assess investment programmes in order to become more resilient to any further deterioration of the business environment.

³⁷ One should point out that reliable information of the Kosovar Diaspora is rather scarce.

³⁸ For data and statistics on the remittance flows see: <http://www.worldbank.org/prospects/migrationandremittances> (accessed on: March 15, 2010).

three years. In 2009, however, one can see a drop of 5.6 percent, in line with the worldwide projected fall in that year (Maddock and Ramguttee, 2009). Is this drop indicative of the current crisis? OECD (2009, p.13) explains that immigrants are generally more vulnerable during a crisis for the following reasons: (i) they tend to be overrepresented in sectors which are more sensitive to the business cycle; (ii) they have less secure contractual arrangements, with more temporary and part-time jobs; (iii) they are overrepresented in less skilled occupations; (iv) businesses owned by immigrants may be more at risk of bankruptcy; and (v) they face potential discrimination in hiring and layoffs. Let us draw on some of these points. With regard to the first point, sectors with excessive sensitivity towards business cycles are manufacturing and construction. In this context, CBK (2010) reports for both the Euro Zone countries and SEE, based on EUROSTAT data, an increase of the unemployment rate in 2009, especially in the manufacturing and construction sectors. As for the Diaspora, the Riinvest Institute (2007) reports that over 50 percent are employed in these sectors (38.6 and 13.0 percent in construction and manufacturing, respectively). As a result, the adverse effects of the crisis on these Diaspora categories are inevitable. In addition, the Riinvest Institute (2007) also reports that over 80 percent of immigrants work in low-skilled professions, and usually, when a crisis hits, it is the low skilled workers who are the first to be dismissed. All these arguments suggest that the Kosovar Diaspora has most likely been hit harder by the crisis - perhaps much more than official estimates show. As the crisis struck, it therefore has probably affected the ability of the Diaspora to remit funds to families back home in Kosovo. This is highly significant, since if the prognosis is accurate, it would deprive Kosovo citizens from a source of income that has been the lifeblood of the economy for many years.

Summary

In a poll conducted by the United Nations Development Programme in April 2009, over 80 percent of Kosovo citizens reported their belief that the global crisis is having an adverse effect on Kosovo. Basically, in this short note I have attempted to confirm whether this widespread belief is based on firm grounds. I have identified and discussed a number of transmitting channels of the global economic crisis on Kosovo's economy. The analysis concentrated on assessing the impact of the crisis through a number of economic integration factors such as financial integration³⁹, trade and the Diaspora. I took this perspective because economic integration has been a major growth engine in the countries of the region, but has at the same time proved to be the Achilles' heel for these

³⁹ In the context of financial integration, I have treated here only the banking sector as it covers 78 percent of assets in the financial sector. Another, although less significant component of the financial sector in Kosovo, is the pension fund with over 13 percent of the total assets of the financial sector. The share prices of the Kosovo Pension Savings Trust (which manages 99 percent of total assets) have seen a significant drop in 2008 as a result of crisis. At the end of 2009 share prices have been stabilizing (for more details see CBK, 2010).

countries as it has exposed them to macroeconomic and financial vulnerabilities. As the above analysis has shown, however, Kosovo has been the least integrated country in the region and consequently it has avoided the full impact of the crisis.

However, as the analysis has shown, the effects of the crisis have been quite noticeable with regard to trade and remittances. Concerning the former, the crisis has hit commodity exports especially hard. Concerning the latter, employment among the Diaspora has been badly affected and the available data imply that there has indeed been a drop in remittances in 2009. As for the banking sector, there are few indications that the sector was badly affected. The main visible effect of the crisis on the banking sector was on credit growth, which dropped significantly relative to previous years. In terms of foreign capital inflow, the significant drop of FDI was more associated with the privatisation process rather than with the global crisis.

Both the IMF (2009) and EC (2009) warn that it is premature to conclude that the risks emanating from the global crisis have completely disappeared for Western Balkan countries. However, the discussion here indicates otherwise, at least in some respects. Since the second quarter of 2009 there have been encouraging signs of recovery, especially in the trade sector, and the major commodity exporters appear to be going back to business as usual. On the other hand, by the end of 2009, credit growth had not returned to its previous high levels. With regard to remittance flows and FDI inflows, there are no official data available to show how these have behaved since the effects of the crises started to fade. However, concerning the former, there have been suggestions that the remittance flows will pick up due to their inherent resilience to economic downturns (see Maddock and Ramguttee, 2009).

On a final note, the 3.8 percent GDP growth achieved in Kosovo during the period of crisis is admirable by any standards. However, I should point out that the major driver of growth in Kosovo, which has helped to mitigate the impact of the crisis, has been the high level of public investment, absorbing over 20 percent of the government budget (see EC, 2009; IMF, 2009). This stimulus, which fortuitously coincided with the onset of the crisis, helped significantly to maintain the level of aggregate demand. To conclude, there seems to have been two fortunate events which have offset the impact of the crisis in the case of Kosovo: on the one hand, the low level of economic integration and, on the other, the shifting of the government priorities towards capital investments.⁴⁰ Beyond the crisis, policymakers in Kosovo should

⁴⁰ This should not indicate that Kosovar institutions have ignored the effects of the crisis. On the one hand, CBK has introduced two measures in response to the crisis: (i) introducing a maximum level of 20 percent of total assets that banks can be exposed to their mother companies and (ii) setting up a crisis management team and conducting non-regular

particularly reassess the economic integration aspect. Although it proved to be a fortunate element in mitigating the effects of the crisis, it is also one of the main barriers to the further economic development of Kosovo. In the medium to long run, policy steps should be taken to greatly enhance the level of economic integration, which has been a determining factor in the growth of most other ex-communist countries over the past two decades.

examinations of the two major banks. On the other hand, the government has established a €200 million 'stabilisation reserve', in the 2009 budget, in case of unforeseen events. How effective these measures were to shield the Kosovar economy from the crisis is not known.

CHAPTER 10: Macedonia: the impact of the global economic crisis

Trajko Slaveski⁴¹

Background issues

The Republic of Macedonia has been praised recently by the IMF for the macroeconomic policies it implemented during the global economic crisis, “which contributed to a modest downturn in Macedonia’s economy relative to other countries in the region” (IMF, 2009b). The IMF also anticipates a return to growth in 2010⁴². However, the IMF sees the large—albeit reduced—current account deficit in the context of an exchange rate peg as a source of vulnerability that limits the room for policy manoeuvre. In the near term, according to the IMF, supporting growth in the Republic of Macedonia while reducing external imbalances will remain the key challenge.

Macedonia experienced a difficult and protracted transition to a market economy due to various external shocks and internal problems in the 1990s and at the very beginning of the 21st century. Pre-transition GDP levels were not restored until the middle of this decade because robust GDP growth was delayed until 2004-2005. Unlike some more advanced transition countries, Macedonia did not experience the large capital inflows from the West that spurred economic growth but brought trouble later on. Being “spared” the excesses of a property boom fuelled by low-cost credit, Macedonia was able to avoid some of the worst consequences of the financial crisis and to become aware of the limitations of this model of growth for its economy.⁴³

Pre-crisis policy reforms

The Macedonian financial system proved resilient in the face of the global financial crisis in 2008 even though the last quarter of 2008 saw a collapse in export demand and the loss of external financing. According to the IMF, Macedonia benefited from a sound banking system, a low level of public debt, and a significant foreign exchange reserve buffer (IMF, 2010). In addition, structural

⁴¹ The author wishes to thank Josef Brada from the Arizona State University and Mihail Petkovski from UKIM for valuable comments on this draft.

⁴² Initial estimates for GDP decline in Macedonia in 2009 are close to 1%, and the projection for growth in 2010 is 2%. The budget deficit in 2009 was within the projected 2.8% of GDP.

⁴³ The top leadership of the winning party in the 2006 parliamentary elections, VMRO-DPMNE, had high hopes for attracting FDI into real estate construction, including tourist and sport facilities, office space and residential buildings, following the experience of other Central and East-European countries in previous years.

reforms implemented by the government before the crisis hit have also helped the country to better weather the crisis. Lower tax rates and improved tax collection secured higher budgetary revenues and a level playing field for the enterprise sector; Customs Office services improved in quality, with reduced fees; labour market flexibility improved; the time needed for company registration was reduced to a business day, etc. These reforms have secured Macedonia a prominent place in global rankings such as the World Bank's *Doing Business Indicators* (among the top 10 "fastest reformers"), and the *Global Competitiveness Report*.

During the past two years there has been a lively debate about the efficacy of the fiscal stimulus as a countercyclical measure. The arguments follow the old divide between neoclassical and New Keynesian macroeconomics (see Barro, 2009, Becker and Murphy, 2009, and Mankiw, 2009). At the heart of this debate has been the value of the public spending multiplier and its impact upon the growth of aggregate demand and GDP. The neoclassical school is quite vocal in claiming a low value, possibly even below 1, showing the inefficiency of the government fiscal stimulus. The New Keynesians disagree, claiming a value for the multiplier above 1.⁴⁴

Expansionary fiscal policy, in particular the projected (and realized) fiscal deficit in Macedonia in 2009 of around 2.8%, has been advocated and advertised by the government as an anti-recessionary measure. However, no debate emerged in the country over the likely effect of such a fiscal stimulus in a small, open economy, where leakages in aggregate demand through imports would be quite large. The fall of economic activity resulted in a fall in revenue collection, which forced the government to rebalance the budget cutting both the projected revenue and expenditures twice in the course of 2009 in order to stay within the initially projected budget deficit. The cuts were said to be higher in the expenditure categories with a significant import component, in order to reduce the trade and current account gaps.

The fiscal stimulus itself could arise not only from fiscal expansion, but also from tax cuts. Recent research favours tax cuts and automatic stabilizers as better instruments to stimulate the economy during a recession (Alesina and Ardagna 2009). In this regard, Macedonia has undertaken significant reforms that have to some extent gone unnoticed by observers. Starting on 1st January 2007, the Macedonian government introduced a flat tax regime, simultaneously cutting the tax rates on personal income (from 15%, 18% and 24% to 12%, and down to 10% from 1 January 2008) and on corporate income (from 15% to 12%, and to 10% from 1 January 2008). Although these measures

⁴⁴ The White House CEA Chairwoman, Christina Romer, has estimated the value of the multiplier from public spending for the US economy at 1.6. See: Romer (2009).

were met with reservations, including those of the IMF, this tax reform brought significant benefits. Lower taxes, combined with a stronger Public Revenue Office, brought significantly more revenue for the budget. Also, although there are no empirical studies, the lower taxes benefited the private sector, too. In addition to already low rates on corporate income, Macedonia decided to free all retained earnings from tax, which represented the backbone of its “anti-crisis” measures, starting from 1 January 2009.⁴⁵ Therefore, the fiscal policy in Macedonia during the global crisis was a combination of tax cuts and fiscal expansion.

In addition to this, after careful preparations, on 1 January 2009 the government launched a reform of the social contributions included in payroll taxes, integrating the collection of pension and disability, health care, and unemployment insurance contributions by the Public Revenue Office and reducing the cumulative burden from 32% to 28.4%. The end-year revenue figures have shown the success of this reform, not only in terms of collected revenue. Unlike tax revenues, which came far short of the initial government projections forcing the government to revise the budget projections twice during 2009, social contributions were collected as initially projected. This success reduced the pressure on the budget and allowed the government to cope with fiscal problems in other fields. Further, a significant further reduction in the social contributions rates took place from 1 January 2010.

Tax and social contributions reforms, whose planning and implementation were unrelated to the Great Recession of 2007-2009, represented a significant buffer that assisted the Macedonian economy during dire economic times. Without any doubt, without these policy reforms the negative consequences of the global economic crisis would have been much more serious for the Macedonian economy with its extremely limited fiscal policy options.

The impact in the coming years

Although Macedonia experienced relatively lower GDP decline compared to the average fall in GDP in SEE countries, the projections of the leading international institutions point to a rather slow economic recovery, due mainly to the unfavourable structure of its exports and other structural weaknesses. Having in mind the low level of per capita incomes and high unemployment, this

⁴⁵ Although it was clear that this would contribute to additional loss in revenue (only 50% of the initially projected profit tax revenue was collected during 2009) the Government decided to implement this radical measure to support both domestic and foreign investment, particularly after the failure of the country to become a NATO member with the Greek blockade at the NATO summit in Bucharest in 2009.

practically means that the global crisis will hamper the real convergence of the Macedonian economy towards the EU countries.

Both the European Commission and the European Parliament have recommended the start of negotiations for Macedonia's accession into the EU, more than four years after the country was awarded Candidate status in December 2005. These bodies agree that Macedonia has fulfilled all the necessary requirements for the start of negotiations. However, the actual start of negotiations has been made conditional to the resolution of Macedonia's dispute with Greece over the country's name. The resolution of this problem is more important for the progress of Macedonia towards the EU at the moment and in the near future relative to other considerations. It is extremely difficult to make predictions on a foreseeable resolution of the issue, having in mind the still distant and somehow rigid positions of both countries' governments in the negotiating process. Greece has enjoyed (and to a certain extent abused) the advantage of full EU membership with veto power and its present (and future) economic problems might distract it from applying more energy to resolving the dispute with Macedonia. Unfortunately, there is no international mechanism that would impose a binding solution in the framework of international law.

Despite the complicated political relations between Macedonia and Greece, burdened for almost two decades by the Greek objection to Macedonia's constitutional name, Greece is one of the biggest trading partners and investors in Macedonia. The old rule that trade and economic relations between neighbours tend to be quite intensive applies here as well. Many in Macedonia now wonder about a possible negative impact from the development of the Greek debt crisis. The same question, although on a much narrower scale, was already raised two years ago, in the fall of 2008, with the outbreak of the global financial crisis. The National Bank of Greece (NBG), one of the biggest players in South Eastern Europe, owns the biggest bank in Macedonia, Stopanska Banka A.D. Skopje. In addition, another Greek bank is also active in Macedonia, though with a smaller market share.

Stopanska Banka, like the entire banking system in Macedonia, fared quite well during the banking crisis. Macedonian banks entered the period well capitalized, adequately regulated, and focused upon traditional, and safe, banking operations. They also relied mostly on the domestic deposit base, and the share of foreign assets did not exceed 7%. In the case of Stopanska Banka, one curiosity should also be mentioned. Several weeks before the fall of Lehman Brothers the Greeks injected around €25 million into its capital base to support its local operations. Stopanska Banka made a

relatively good profit in 2009, and according to bank sources, it was probably the best performing bank of the whole NBG system in the region.

However, with the looming debt crisis in Greece, new dangers and uncertainties have appeared on the horizon. This is something to which authorities in Macedonia should pay utmost attention. So far, the National Bank of Greece has been the best performing Greek bank, and it seems that its balance sheet is solid. It remains to be seen to what extent a negative and disorderly evolution of the debt crisis in Greece might have upon its banks. In such a case, definitely, operations of the Greek banks in the region will be adversely affected.

The expected negative impact of the Greek debt crisis upon its neighbours' economies exemplifies a more general phenomenon - that of a possible sovereign debt crisis in the near future. There is significant concern that other countries in the EU periphery, including Portugal, Ireland and Spain and even Italy, infamously now called the PIIGS, might be affected. Some authors (Fergusson, 2010) have even warned that the sovereign debt crisis might soon spread to advanced countries, including the USA and Great Britain. Such a scenario will certainly have a further negative impact upon the world economy in general, and the economies of the SEE countries in particular.

In the case of a prolonged recession in Greece due to an inevitable austerity program, deflation and rising unemployment, Macedonia will also suffer. The fall in the living standards of Greek citizens will reduce the earnings from cross-border trade and tourism for Macedonian businesses, and Greek FDI in Macedonia will decline in the short and medium term. One may expect that the Greek firms that have already invested in Macedonia, or that planned to do so, will come under pressure to invest their capital in the domestic economy. This will affect not only Macedonia, but also other countries in the region, like Bulgaria, Serbia, and Romania.

The lesson from all this for Macedonia and the other countries of South Eastern Europe is that the growth model that lifted the economies and living standards in the Central European countries, and the Baltic States in particular, to previously unseen and perhaps unsustainable levels during the decade or so before 2008, disappeared with the Great Recession of 2007-2009 and will not reappear in the foreseeable future. Therefore, in the future these countries will need to rely upon their own sources for growth more than before⁴⁶. Private capital inflows will retain their importance, but

⁴⁶ In the case of the Republic of Macedonia, this recommendation has been put quite eloquently in an excellent report published last year, prepared by a panel of foreign experts led by Prof. Josef Brada from Arizona State University for the

within a framework of a *modified* growth model where these inflows will be more directed to an increase of supply, preferably in the tradable goods sectors, rather than production of consumption goods and services (see also Belka, 2010).

Conclusion

The global economic crisis, now dubbed the Great Recession of 2007-2009, has limited the options for growth in Macedonia and the other SEE countries as well. Greater reliance upon own resources, shift of resources and reduced capital inflows towards the tradables sector and more efficient use of EU pre-accession funding will be crucial in the future. These countries, including Macedonia, might benefit from further structural reforms and institutional development, fostering the rule of law and fighting corruption. A possible spread of the sovereign debt crisis, which is closely related to the global financial and economic crisis of the past two years, will significantly worsen the growth prospects of the SEE countries. Therefore, the EU should consider increasing its pre-accession assistance to some of these countries. In the case of Macedonia, the most important issue with respect to its EU accession is the Greek veto related to the long-running dispute over Macedonia's name.

CHAPTER 11: Lessons for small economies – the case of Montenegro

Veselin Vukotić

A lack of optimism best describes the current situation in the Montenegrin economy. The growing optimism of individuals and companies that increased in strength after the country declared its independence in May 2006, started to evaporate at the end of 2008 when the global financial crisis finally hit the country (later than other parts of the world). Why did the optimism disappear so quickly? This paper answers this question by briefly analyzing events that preceded the high-optimism phase, discussing the factors that contributed to its sharp fall, as well as drawing the lessons that should be learned from the crisis.

Economic Boom

Two key factors that led to the economic boom in Montenegro in the period of 2002-2008 were:

- The introduction of a new economic system after 2000
- The effect of independence in 2008.

At the end of the 1990s, Montenegro drastically changed its economic system. Although it was still a part of the Union with Serbia (FRY - Federal Republic of Yugoslavia), Montenegro began to build an independent economic system ("FRY-two systems within one state"). The idea of free markets was the fundamental aim of the new economic system. Free market ideas had been developing in Montenegro since the mid-1980s and became even stronger during the transition period. A group of young economists influenced by the basic principles of the Austrian and Chicago Economic Schools, both at the University of Montenegro and abroad, largely contributed to the development of such ideas.

These ideas of economic liberalism were the foundation of the new economic system that has been established since 1997. Visas for foreigners were abolished; the average tariff custom rate was reduced from 25 percent to less than 2 percent. Around 80 percent of the economy was privatized rather quickly; new businesses, small and medium enterprises were encouraged; and tax rates were decreased to the lowest level in the region. However, the introduction of the Deutsche Mark as legal

tender in 1999 was undoubtedly the most important step of the reform (it was replaced by the euro in 2002). It contributed to growing interest by foreign investors, both through privatization and through new, greenfield foreign direct investments. The protection of property rights and contracts became a keystone of the new economic system.

Openness appeared to be the only viable strategy of development, especially for a small state, such as Montenegro (with a surface area of just 13.000km and 620,000 inhabitants). In addition, because of this emphasized liberalism, Montenegro and Serbia (members of a State Union from 2003) developed rather different understandings of economics which drew them apart and created a favourable political environment for the independence of Montenegro. Independence was indeed re-established following a referendum held on 21st May 2006 which gained the support of 55.5 percent of the voters. The creation of the new independent state, which was strongly oriented towards free markets and entrepreneurship, encouraged many investors from Europe, USA, Japan, Russia and elsewhere to invest in Montenegro.

During this time Montenegro registered a strong economic performance, as shown by the following data:

- Among the fastest GDP growth in the region -GDP increased from €1,295 million in 2001 to €3,085 million in 2008
- One of the leaders in the region in FDI inflows – in the period of 2002-2008 FDI inflows amounted to €2.3 billion and the average yearly FDI inflow was above 20 percent of GDP
- The euro is used as official currency and the inflation rate has averaged around 3-4 percent per annum
- The unemployment rate fell from 33 percent in 2002 to 10.8 percent in 2008
- A budget surplus was achieved during the period from 2006-2008
- Foreign debt was reduced from 42.6 percent of GDP in 2005 to 27.8 percent of GDP in 2008

Stagnation

The first blows of the financial crisis hit Montenegro at the end of 2008. Thereafter, the economic situation was, without a doubt, dominantly influenced by the crisis. However, as far back as 2007, the first post-referendum government abandoned the reform path set out in the Government strategy document Agenda of Economic Reforms and Development (2007-2011), which continued the direction of economic policy starting from 2002 (Agenda of Economic Reforms 2002-2007). The document warned the government that its lack of “courage” could endanger ongoing reforms in

Montenegro.⁴⁷ Several privatization projects were suspended, which gave a negative signal to investors and, as a consequence, the capital market in Montenegro experienced a severe decline. Furthermore, most pension and labour market reforms were abandoned or postponed.

The case of Montenegro confirms the importance of two lessons learned from the experiences of other countries. First, reforms are not possible without political will and courage, i.e. the self-confidence of a nation is an important economic factor. Second, the case of Montenegro supports the somewhat ironic claim by Zakaria (2009) that success is an essential cause of the global crisis. Being intoxicated by success, we often fail to examine its real sources and neglect any problems that may arise, including structural problems.

Two important structural problems I have in mind are:

1. The distorted relation between tradable and non-tradable goods reduced the export possibilities of the Montenegrin economy. Economic growth failed to bring about a qualitative upgrading of the tradable goods sector, which would have led to stronger export performance and competitiveness. This was of fundamental importance since the adoption of the Euro as the official currency deprived policy makers of the ability to use currency devaluations as a tool for export promotion. Foreign and domestic investments concentrated disproportionately on consumption (including housing and imported luxury goods) and did not channel enough resources into productive investments. This was corroborated by the combination of a liberal economic environment (Montenegro is ranked 68th in terms of economic freedoms on the relevant global rankings) and a relatively underdeveloped legal framework for business activities.
2. The existence of an unfavourable employment structure reflected through the relation between the number of people employed by the state and private sectors. Around 52,000 people work in the state administration (including health and education), which constitutes roughly one third of total employment in Montenegro. The concept of the “micro-state” (Vukotić 2003) was disputed and the state administration continued to mimic the needs and structure of the administrations in some larger countries. As a result, the total wage expenses of state administration still account for about 60 percent of the state budget.

⁴⁷ The document was prepared by an expert group led by a team from the Institute for Strategic Studies and Prognoses, Podgorica.

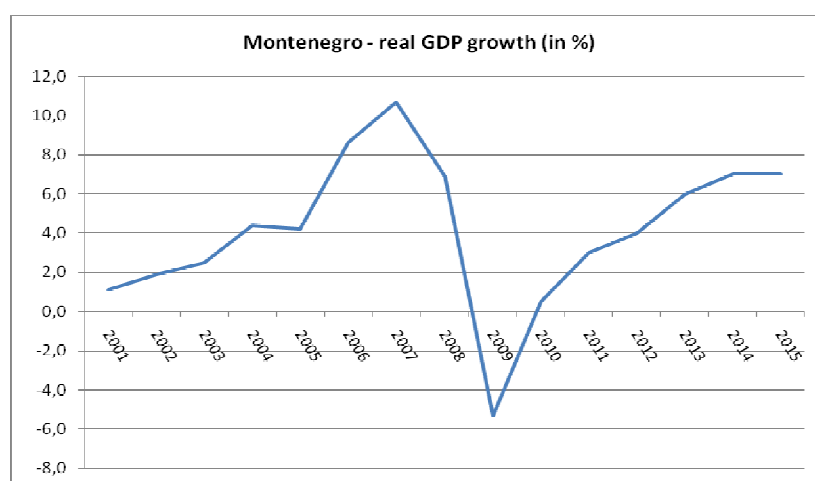
The Decline

A small open economy with insufficiently developed institutions, such as in Montenegro, is highly vulnerable to exogenous shocks and can be severely damaged by a global economic crisis. There are several channels through which the global crisis transmitted its effects to Montenegro:

- Banking flows (financial flows)
- Trade channels (flow of goods and services)
- Sharp fall in FDI
- Falling remittances

The decline of global output and aggregate demand on international markets influenced the GDP level in Montenegro especially through falling prices of some goods (for example aluminium). The GDP trends are given in the graph below.

Figure 1. Real GDP growth in Montenegro



Source: Monstat, ISSP; ISSP's projections

This graph illustrates well all phases of development in the previous decade – growth, decline, and (expected) recovery. The highly unstable GDP growth rates (regardless of sign) demonstrate that the structure of the Montenegrin economy is very sensitive to external shocks from foreign markets in the context of a growth model based on unrestricted inflows of FDI into (mainly) real estate investment.

Economic activities were significantly reduced in the first ten months of 2009. Some of the relevant indicators were as follows:

- Bank deposits were reduced by 15 percent on average
- Domestic savings fell by 12 percent on average
- Bank loans decreased by almost 10 percent
- Interest rates reached the level of 10 percent, even exceeding 15 percent at one point
- Capital markets became unstable and share prices fell by around 60 per cent
- Public debt increased by 27.4 percent of GDP⁴⁸

The main features of the real sector during the same period were as follows:

- Unemployment grew from 10.8 percent to 11.66 percent;
- Exports fell by 33.5 percent;
- FDI inflows were sharply reduced.

This sharp decline of economic activity led the government to engage in informal discussions with the IMF in November 2009 to negotiate a possible loan arrangement of around €150-300 million. Although these talks did not lead to any loan agreement, the possibility of a future loan was not excluded altogether.

The Challenges Ahead

One of the biggest dangers the Montenegrin economy is facing is a highly indebted public and private sector. Households are highly indebted, and paying their loans is becoming a real burden. On the other side, the banking sector does own a significant amount of liquid funds. However, banks are focused on collecting existing loans, not on extending new ones. High interest rates (above 15 percent) are holding back economic activity. It is still uncertain how long the banks will be able to survive without selling their basic product – loans for new projects – and how much time they will need before starting to extend new loans.

When investment is falling, aggregate demand is strongly influenced by public spending. However, the decline of economic activity resulting in a decline in GDP has significantly reduced the tax base and thus the available funds for public spending. Balancing the state budget has become a serious problem. What is the right way out: reducing public spending or increasing taxes? Will an increase in

⁴⁸ Public debt has continued to rise and reached 38.8% of GDP by April 2010 (IMF Public Information Notice No. 10/67, May 27, 2010).

taxes lead to decreased investment in the Montenegrin economy? The IMF proposes a combination of these two measures, suggesting that Montenegro should generate growth from domestic savings, and that reliance on foreign capital inflows should be reduced and limited. This is a major challenge facing Montenegro and its outcome will determine the course of future economic development of the country. Should Montenegro just lean on domestic savings and raise budget loans, or should she follow a development path based on economic freedom and the strong influence of foreign direct investment? Taking new loans can be very dangerous for a small country such as Montenegro, especially if they are used to finance consumer spending. On the other side, a development model based on liberalised markets and economic freedom would ensure that the business environment remains attractive for foreign and domestic investors. It would be hard to expect domestic savings to be invested in an economy that is not fully open for foreign capital.

The liberal economic model based on economic freedom and openness for both domestic and foreign investors is still dominant in Montenegro, but the strength of the opposing model of interventionist development, supported by opposition in the Parliament and a part of the bureaucracy, should not be underestimated. The final outcome will be tested through the realization of several major projects that have already started or are scheduled to start soon (including infrastructure projects, such as the construction of a new highway; promotion of the tourism sector; the development of the energy sector; and support for small and medium enterprise development).

Lessons Learnt

The first reaction, conscious or unconscious, to the crisis is an attempt to close our economy with the explanation that all troubles are coming from the outside, from global markets. This raises the dilemma whether to revert to a closed economy based on the nation state, or to remain open to the global markets. The crisis has shown, and it is becoming more evident especially in small countries, that the power of the state to finance development and efficiently allocate resources is very small. Globalization took away many functions and much power of national states. The traditional role of the state, as well as the belief that politics can solve all economic and development problems, are both changing. Thus, our focus should be on whether and how Montenegro can use global markets for the development of her economy and how can she create an environment favourable for foreign and domestic capital and for foreign and domestic entrepreneurs. In the global economy, although the role of the state is important, it has different functions from the traditional nation-state.

The crisis throws up new opportunities but also emphasizes the mistakes that have been made. It shows that economic systems with high public spending and large share of non-productive activity can be sustained only with high GDP growth rates. In the short-run, these high and positive growth rates can be achieved through some exogenous, non-economic factors. But the question is how can we provide high growth rates in the longer-run? Should growth be driven by state interventionism or by the market, or can a new form of better regulated market that combines economic freedom with greater social responsibility be designed?

The experience under socialism has shown that state control of the economy cannot ensure its long-term sustainability. Critics of the free market development model see the structure of the Montenegrin economy as the crucial problem: a small share of tradable and large share of non-tradable goods in production. The lesson we seem to be learning from the crisis is that the economic structure of a country cannot change without a thorough change of view of the role of the state and the role of the market in the economy. In a small state, we cannot strengthen the role of the state and increase public spending and simultaneously expect the tradable goods to dominate in production structure at the same time.

Besides, we might learn one more lesson from the crisis: human capital and its quality are crucial. People who are used to having a safe job in the state administration while relying on somebody else to solve their problems (usually the state) do not contribute to solving the problems caused by a crisis, but make them even more difficult.

CHAPTER 12: Romania and the global financial crisis: impact and challenges

Ileana Tache and Cristina Neesham

Economic vulnerabilities exacerbated by the crisis

According to the most recent available data, the global financial crisis appears to have hit Romania and the other Central and Eastern European (CEE) countries particularly hard. Although analysts (Van der Voet et al., 2005) at first believed in a “decoupling” of the new EU members, the effects of the global crisis are now visible.

For many years the CEE countries benefited from strong capital inflows and high demand for goods and services. But this abundance disguised vulnerabilities and reduced incentives to diversify economies and implement reforms. During the boom years, countries became increasingly dependent on foreign financing, while the broadening of production structures and the development of local capital markets lagged behind. Once external funding dried up, these problems were not only exposed but made the impact of the crisis even greater.

The severity with which the crisis hit Romania took many people by surprise (Barysch, 2009) but certain unsustainable evolutions of the macroeconomic indicators suggest specific weaknesses that preceded the crisis. Consequently, not all the problems of the Romanian economy can be fairly blamed on the global crisis.

Despite the fact that Romanian people are not prone to taking loans or living in debt⁴⁹, during the transition years a proclivity towards indebtedness gradually developed. As a result, Romania's external deficits grew almost exponentially between 1998 and 2007, with the current account deficit rising from €2.6 billion to €16.7 billion (6.3 times) and widening from 3.7 percent of GDP in 2000 to 12.3 percent in 2008. The medium and long-term external debt of the private sector also increased from 12.9 percent of GDP in 2004 to 25.6 percent of GDP in 2008.

⁴⁹ The debt-free culture is “as old as the hills” among Romanians, this propensity taking a particular form during the past two hundred years, since money-lenders and incipient banking became fairly common in the Romanian territories. However, the financial institutions were considered “parasites” – taking into account that the banks in Romania have never in history been Romanian (this is also true at present, when over 90% of the capital of the banks operating in Romania is held by foreign shareholders) and never tried to save their clients in debt. In modern times, the resentment to being indebted was kept alive in the 1980s through the excessive efforts made by Ceausescu's regime to pay off the foreign debt.

During the period 1998-2007 the GDP leaped from €37.4 billion to €123.7 billion (3.3 times). These data illustrate that every GDP unit added required a doubling of the foreign deficits. These trends could be also explained, at European and international level, by the earlier deregulation that gained ground in the European Union particularly after 1980, encouraging the free movement of goods, services, labour and capital.

Romania has grown dependent on loans in a relatively short time. The causes of this development have been twofold. First, the Romanian government's economic policies have been strongly oriented towards sustaining a level of growth much in excess of the country's internal supply capabilities. Secondly, the low competitiveness of domestic products and the consumer preferences for quality stimulated demand for consumer imports. As this occurred in the context of a low purchasing power of the average Romanian consumer due to low wages and salaries, the result was an orientation of trade towards low priced imports. Further, consumers' purchasing power was stimulated through credits which enabled the development of a market of imported goods generally tendered by hypermarkets.

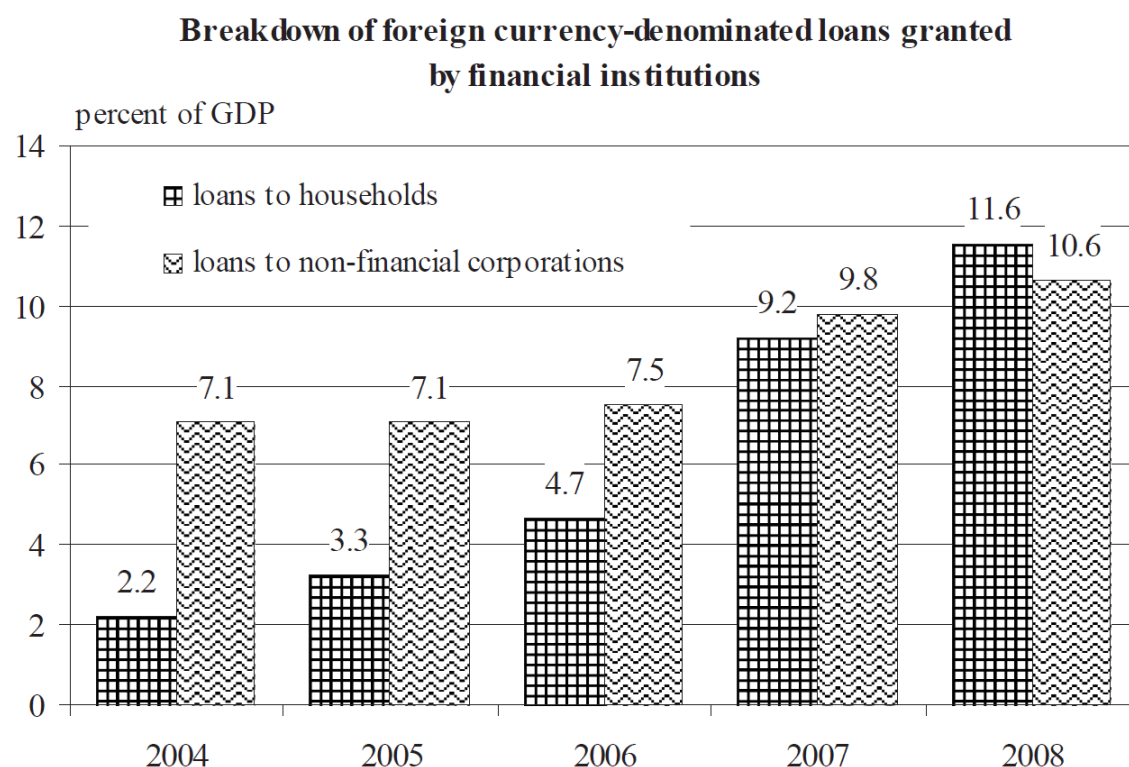
Like other East European countries, Romania witnessed massive capital inflows before the crisis. The surge in capital flows was controversial from the standpoint of its effects upon an emerging economy like Romania. On the one hand, it fostered economic growth, confirming Mishkin's (2007) opinion, according to which financial development and economic growth are strongly linked. The great volume of incoming FDI enabled the country to benefit from higher capital accumulation, acquire expertise in dealing with financial issues and upgrade the financial services sector. On the other hand, capital mobility across boundaries created high risks for the Romanian economy: beside potential speculative attacks on the national currency, the menace of macroeconomic destabilization existed due to portfolio investors' unexpected behaviour. When "hot money" flows in, the effects are positive: the cost of capital for local companies will edge down while wages and salaries will be driven up; when "hot money" flees the country, it will leave a currency crash in its wake, throwing the economy into recession (Frankel, 2005).

Initially, the capital inflows in Romania led to an appreciation of the exchange rate in both real and nominal terms. The "leu" appreciated in nominal terms from nearly RON/EUR 4.1 in January 2004 to RON/EUR 3.1 in July 2007 (about 24 percent). The large capital inflows became a matter of serious concern regarding the implementation of inflation targets adopted in August 2005. While facilitating

disinflation, the “Leu” appreciation was so strong that it tended to affect Romania’s external competitiveness.

The appreciation of the domestic currency and the surge in banks’ foreign currency holdings boosted lending in foreign currency. Loans expanded at annual growth rates ranging from 60 percent to 80 percent in real terms. The share of foreign currency-denominated loans to households grew more than five times, from 2.2 percent of GDP in December 2004 to 11.6 percent of GDP in 2008. The share of foreign currency-denominated loans to the corporate sector also grew substantially (see Figure 1).

Figure 1



Source: National Bank of Romania, 2009 (www.bnr.ro)

The negative effects of the crisis translated into the real economy. Loans denominated in foreign currency became more and more expensive, thus weakening the possibility of repayment. The immediate impact was the increase of doubtful and loss making loans in the bank balance sheets. The delays or even inability to repay the loans led to a sharp fall in house prices.

Banks came to rely heavily on external financing, while the mismatch between foreign currency denominated assets and the foreign currency liabilities of companies and households increased. In

2004, the excess of foreign currency denominated loans over deposits in the non-financial corporate sector of around 5 billion lei, increased sevenfold by March 2009 to 34 billion lei. For households, an excess of deposits of 5 billion lei turned to an excess of loans of 28 billion lei over the same period (National Bank of Romania, 2010). These imbalances between foreign currency denominated assets and foreign exchange liabilities of companies and households constitute one of the greatest vulnerabilities in Romania's economy. These are in fact the main channels through which the halt in external financing caused by the global financial crisis leads to exchange rate depreciation (Isarescu, 2009b).

These developments reinforced each other, so that during 2005-2007 there were periods when inflation expectations (caused by strong pro-cyclical pressures, the flat tax of 16% and high wage rises, which increased revenues available to both individuals and firms) coexisted with a markedly stronger domestic currency. Therefore the central bank was confronted with a serious dilemma in terms of the newly-adopted monetary policy regime. Policy rate hikes, required for bringing expectations in line with the inflation target, attracted further foreign capital, which entailed the appreciation of the leu. During 2005-2008, the National Bank of Romania had to make discrete interventions in currency markets by purchasing considerable amounts of foreign currency in the attempt to prevent the fast appreciation of the leu. The appreciation was likely to cause a dangerous erosion of the external competitiveness and to lead to a fall in inflation, in an unsustainable manner.

Another vulnerability of the Romanian economy was the pro-cyclical conduct of fiscal policy, which added to excess demand. Romania opted for an imprudent fiscal policy in the interval 2004-2008, as the authorities believed that "good times" would last for ever and that excessive government spending was permitted. Moreover, 2008 was an election year, which contributed extra pressure on the national budget. The natural result of the subsequent economic downturn was thus a severe fiscal contraction.

In effect, Romania had to confront both a global economic crisis and a self-inflicted budgetary one, brought about by poor public governance and irresponsible resource allocation (Romanian Academic Society Yearly Forecast, 2009). It was to be expected that allowing large budget deficits while the economy was expanding would end in failure. Romania would have found it much easier to weather the global financial crisis had the national budget been in surplus, or at least in a smaller deficit, in the previous two years (Isarescu, 2009a).

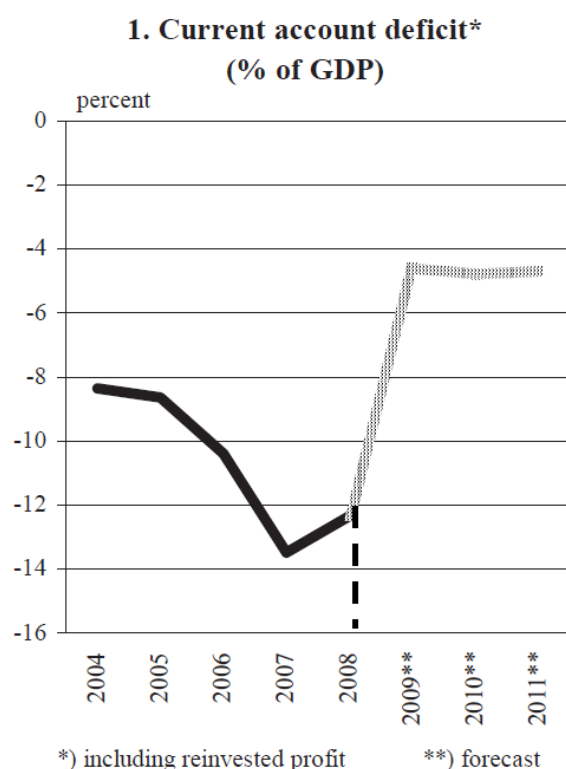
Recovery potential and perspectives

As recent studies (Kittelman et al., 2006) have shown, in the case of Romania and the other new EU member states the majority of crises of the last ten years have been generally caused by inconsistencies in the domestic policy mix, which contributed to the deterioration of the country's macroeconomic condition. Unfortunately, policy makers in these countries lack the degree of sophistication required to identify and apply those economic policies that are likely to be most effective during downturn periods. In any case, it is anticipated that Romania will probably see a gradual economic recovery in the period to come. A positive economic growth of at least 0.5% is expected in 2010, as compared to minus 8% in 2009. In 2011, the trend will apparently be maintained, given the European Commission's forecast of 2.5% economic growth in Romania. The expected developments in the Romanian GDP, inflation and current account deficit are presented in Figure 2. In keeping with the commitments made to the international financial institutions with which it signed loan agreements, Romania should ensure a budget deficit of a maximum of 5.9% in 2010 and 3% in 2011.

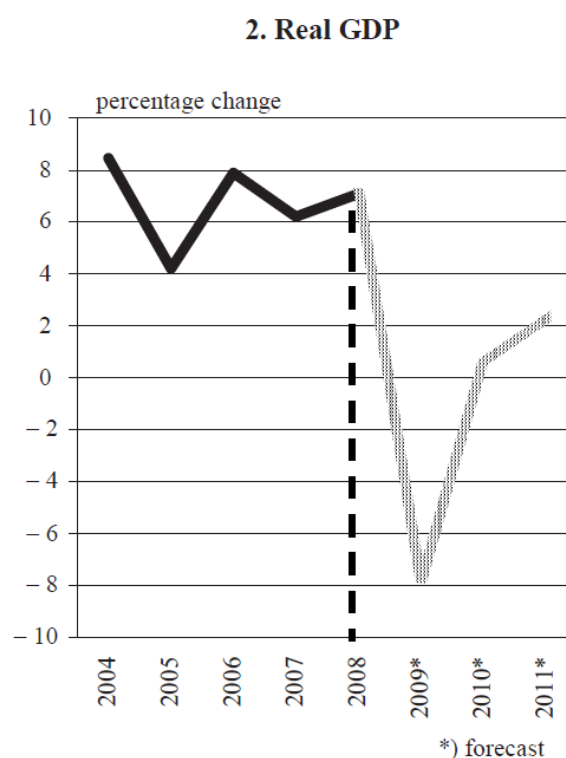
Different EU member states seem to have coped with the crisis in different ways and anti-crisis measures have been specific to each country. In Romania, the crisis had to do with too much consumption and too little savings, so restrictive measures had to be implemented. Romania now has to reduce interest rates. This does not translate, however, into a burden on the state budget, but a better coordination between political actors and decision makers in the economy. No country can overcome a crisis, regardless of its nature, if it maintains a reference interest rate of 7-8%. In the euro zone, this rate stands at a mere 1%.

Romania should not necessarily follow the example of those states that can afford to spend a lot on stimulus packages, nor wait for the large EU economies to overcome the crisis expecting that this will help the country overcome its own crisis as well.

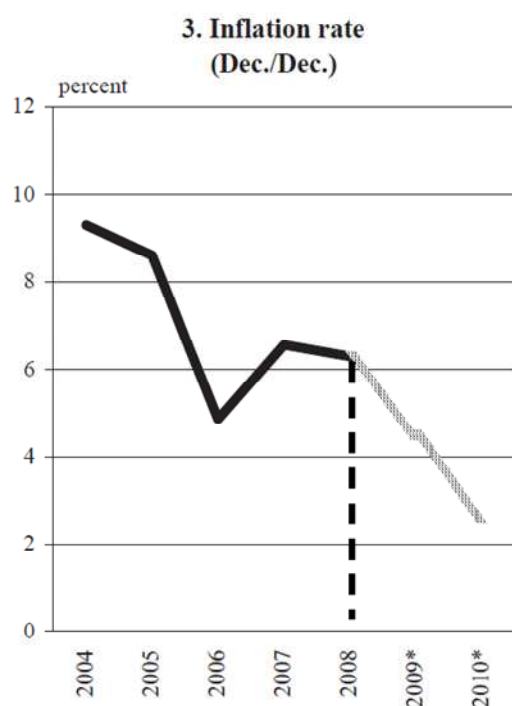
Figure 2



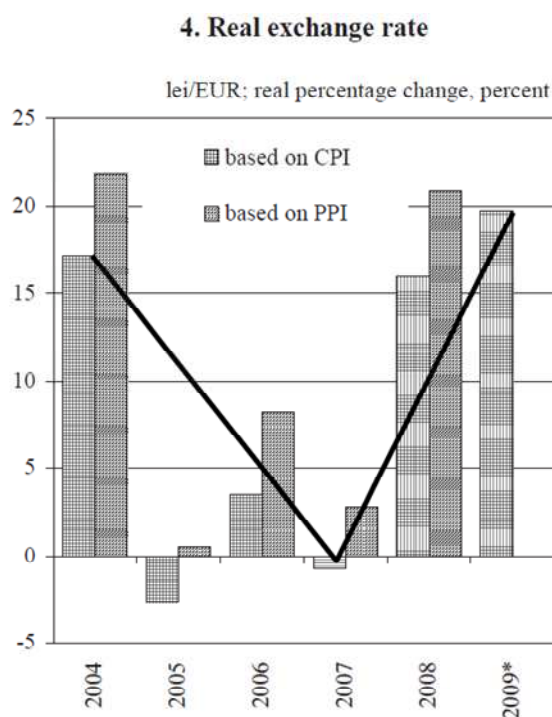
Source: National Bank of Romania,
National Institute of Statistics
National Commission of Prognosis, 2009



Source: National Bank of Romania,
National Institute of Statistics, 2009



Source: National Bank of Romania,
National Institute of Statistics, 2009



Source: National Bank of Romania
National Institute of Statistics
National Commission of Prognosis, 2009

The greatest problem for the Romanian economy lies in the management of public money. The macroeconomic balance cannot be restored in the absence of a sustainable fiscal position. The approach to the fiscal position should be consistent with the present economic situation, supporting an adequate adjustment program. It means placing the high performance of publicly financed activities at the centre of public policy and allocating public funds strictly on efficiency criteria (Donath & Cismas, 2008). If the government fails to finance productive investments (e.g. infrastructure, which is necessary in the long run, in order to fight unemployment) and continues to channel funds towards loss making areas, it will only contribute to deepening the crisis.

As far as the banking system is concerned, its position has proven relatively strong. This is due to the tight monetary policy led by the Central Bank, which involved high reserve requirements acting like a cushion for banks with temporary liquidity problems.

For a country like Romania, irrespective of the global financial crisis, the medium-term reform challenges remain the same, namely streamlining the social security system and increasing investment in education, research and development. Such structural reforms are needed if the country is to continue to catch up with West European income levels and to survive the fierce current global competition.

Conclusions

At present, Romania is in a fragile state. Economically, it has been seriously affected by the global financial crisis and all is not over yet. According to Business Monitor International (2010), while the lowest point of the recession seems to have been left behind, instability is likely to continue to characterise any recovery efforts, at least for a while.

Indeed, the future may still hold pitfalls in which the economy may get trapped, due to its enhanced vulnerability to exogenous shocks created by financial globalization. The positive effects of the latter have partly been cancelled out by other, more perverse effects, such as increased consumption and capital outflows.

Global financial integration has had another disruptive effect, namely that of prompting the government to divert resources away from more urgent development priorities (such as education, public health, and industrial capacity) into seeking financial stability. The financial globalization

process is beneficial but difficult to harness. As resisting globalization is not an option, good management and well-inspired economic policies are necessary for coping with the consequences of this crisis.

Our account of Romania's current economic situation identifies no less than seven major vulnerabilities. These 'seven capital sins' are:

- increasing dependence on foreign financing coupled with a lack of development of domestic capital markets and production structures;
- an unprecedented growth in household borrowing;
- the dominant market power of a small number of foreign companies, combined with the low competitive capacity of Romanian companies;
- the high risks involved in massive FDI, such as unpredictable portfolio investor behaviour and unregulated speculation against the national currency;
- the risk of the exchange rate fluctuations not necessarily determined by foreign capital inflows;
- a procyclical conduct of fiscal policy, which led to excessive government spending; and
- a self-inflicted public money management crisis, caused by poor governance and lack of higher-order strategic thinking in complex policy design.

Nevertheless, the most recent economic performance indicators suggest that there is potential for a slow (rather than spectacular) recovery and a reduction in public budget deficits, while the banking system will maintain a strong position. In addition, it is recommended that proactive measures should include the reduction of interest rates, superior allocation of public funds based on performance and efficiency, and focus on effective infrastructure development.

Our analysis shows the need for deliberate policy intervention to eliminate the tremendous inefficiencies created by the seven major vulnerabilities summarised above.

CHAPTER 13: Economic crisis in Serbia: impacts and responses⁵⁰

Pavle Petrović

Introduction: economic imbalances before the crisis

Before the onset of the global economic crisis, Serbia achieved a relatively high rate of economic growth over a number of years with real GDP growing at rates between 5% and 6% per annum. This growth was mainly generated by the non-tradable sector, driven by a large inflow of capital, leading to large external deficits, with a current account deficit of 15% of GDP and a trade deficit of 22% of GDP. These deficits implied that Serbia was consuming and investing well above its level of current output. The current account deficit was covered by foreign savings, as Serbia took advantage of financial integration with the EU, which enabled banks from neighbouring EU countries to dominate the banking sector. However this economically rational 'downhill' flow of capital from developed to transitional Europe (Abiad et al., 2009) was quite excessive in the case of Serbia, taking into account underlying parameters (low per capita income and a low degree of financial integration). Thus Serbia exceeded her natural 'speed limits' of output growth, and became highly vulnerable to the various external shocks that struck her during the crisis. This experience has revealed the downside of financial integration with EU.

The sizeable trade deficit in Serbia shows that she has not achieved a high degree of trade integration with the EU and that Serbian companies have failed to connect with EU production networks. In that respect it is similar to other South East European countries, while being quite different from most Central European ones. The inflow of capital has been channelled into the non-tradable sector, including domestic trade, banking, transport and telecommunications, which were responsible for 80% of overall growth in the last decade (Vasiljević 2009). At the same time a significant and continuous process of deindustrialization has been underway leading to a deep restructuring of the economy.

The large inflow of capital which occurred since 2005 and the consequent high growth of output invoked a strong real appreciation of the domestic currency (the dinar) of some 26%. This

⁵⁰ The paper heavily draws on analysis and data given in various issues of the *Quarterly Monitor of economic trends and policies in Serbia (QM)*, FREN, available in English at www.fren.org.rs. Unless stated otherwise sources for this paper are from various issues of *QM*.

considerably reduced the competitiveness of the Serbian economy and stimulated investments in the non-tradable sector. A further consequence has been the very low level of exports which is now less than 30% of GDP. Nonetheless, weak exports are linked to the fact that Serbia is a latecomer in transition, having initiated serious reforms only from the beginning of the 2000s. In fact, the pace of export growth increased substantially after 2004, i.e. when the initial reforms were completed, suggesting that Serbia might eventually join the club of transition countries that have achieved high trade integration with EU.

The crisis and the sudden stop in capital inflows

The world financial crisis, which began in September 2008, brought an abrupt halt to the inflow of credits in emerging Europe (Berglof et al. 2009). The effects were particularly strong in Serbia causing a 'sudden stop' crisis. Before the crisis, the increase in credits to the nongovernmental sector (real sector and households) was approximately 20% per year. These credits were based mainly on foreign savings, while the limited domestic savings were mainly in foreign currency. When the crisis hit, the foreign sources of savings dried up and a large amount of domestic foreign currency savings was withdrawn from Serbian banks. This caused a more or less complete halt in new credit extensions. Consequently, domestic demand dropped substantially, pulling down output in its wake.

The second channel through which the global economic crisis hit Serbia was through a sharp decline in exports. However, since the share of exports in GDP was in any case very low, the negative impact on output was only a secondary factor in the decline in output.

Table 1: Real GDP growth and the components of its decline in 2009 (% per annum)

| | Real GDP | Aggregate demand | Domestic demand | Export demand | Imports |
|------|----------|------------------|-----------------|---------------|---------|
| 2009 | -3% | -8.1% | -6% | -16.8% | -24.5% |

Source: *Quarterly Monitor, FREN, Belgrade, 2010*

The drop in aggregate demand in 2009 was deeper than that of output, reflecting the forced downward adjustment of the external deficit. Moreover, although the decrease in domestic demand was considerably less than that of export demand, the former had much higher share in total aggregate demand and hence contributed by 55% to its decline; the remaining 45% was due to a fall in export demand. Unemployment has increased substantially and has persisted throughout the crisis: the unemployment rate increased from 14.7% in October 2008 to 19% in June 2010.

The large decline in domestic demand led to a huge drop in imports, thus bringing about a significant downward adjustment in the current account deficit from above 15% to below 10% of GDP and also in the trade deficit from 22% to 15% of GDP. However these deficits are still high and may well increase upon recovery, so they remain important elements of the imbalances in the Serbian economy.

Upon the sudden stop in capital inflows, the domestic currency depreciated by 23% in the five months starting in October 2008 and then stabilised throughout 2009. This has been a welcome adjustment, as it mitigated the decline in output. Thus Serbia's experience adds to the mounting evidence that the recession has been weaker in countries with flexible exchange regimes compared to those with fixed exchange rates (Berkman, 2009). Despite the large and abrupt depreciation, the pass-through into inflation has been very modest in Serbia – less than 20%. Obviously this low pass-through can be explained by the accompanying recession, specifically by the significant drop in domestic demand (see Table 1) that prevented a rise in inflation. Finally, the exchange rate depreciation led to a partial recovery in Serbia's competitiveness that had been lost during the period of surging capital inflows and the related real exchange rate appreciation from 2005 to mid-2008.

While the 3% decline in output in 2009 was substantial, it was nevertheless below the decline which took place in other economies in South East Europe and in addition the Serbian economy exited from the recession in the first half of 2010.

Policy response: monetary and exchange rate policy

Fortunately, Serbia took advantage of support from the IMF prior to the eruption of the global financial crisis, a factor that helped to focus her policy on appropriate responses to successfully navigate through the crisis.

Having adopted inflation targeting and a flexible exchange rate regime, Serbia reacted to the external 'sudden stop' shock by allowing its currency to depreciate significantly. This was a controlled depreciation with the central bank intervening heavily by selling its foreign currency reserves to limit the extent of depreciation. The aim of intervention was to avoid sharp drops in the value of the domestic currency, hence preventing panic and a possible overshooting of the exchange rate. Nevertheless, the central bank did not defend any particular level of the exchange rate, instead

allowing for the necessary adjustment to take place. It was not an easy task since the Serbian economy is characterized by a high level of euroisation of its financial sector. It is estimated that about 70% of all extended credits are indexed to the Euro. Therefore there was a danger that currency depreciation would trigger massive credit defaults, as the cost of repayments of outstanding loans increased considerably in terms of domestic currency. Fortunately, this pessimistic scenario did not materialise and the amount of nonperforming loans has remained at tolerable levels. It is interesting that Croatia, which is also a highly euroised economy, opted for a much stronger defence of her currency and consequently experienced only a minor depreciation, but also a far larger output decline.

The exchange rate stabilised at the beginning of 2009 and remained almost constant throughout the year, presenting the most vivid sign that the worst phase of the crisis had passed. Two main factors contributed to this stabilisation. Firstly, the Stand-by Agreement with IMF, which besides focusing on achieving a sustainable budget deficit, offered €3bn support to the economy over two years. This covered most of Serbia's foreign currency needs in 2009 as the current account deficit dropped considerably due to the effects of the recession (see above). Secondly, the Vienna Initiative (an agreement reached between the IMF, EU banks operating in SEE, and the SEE countries, to preclude capital outflow from the region) was also vitally important in preventing a currency collapse. Thus the downside of financial integration with the EU, associated with excessive capital inflows, has also had an upside by preventing abrupt capital outflows. This outcome in Serbia is in line with the broader empirical evidence that has been shown to characterize the effects of the global economic crisis throughout emerging Europe (Berglof et al., 2009).

Furthermore, additional measures have been taken by the Serbian central bank, such as lifting all the impediments to capital inflows that were introduced in the pre-crisis period, and offering incentives to switch from euro-indexed credits to dinar credits. Nevertheless the effects of these measures have been quite limited.

Policy response: fiscal policy

Since fiscal policy in the pre-crisis period was pro-cyclical, Serbia was ill-prepared to use this instrument of policy when the crisis hit. The large inflow of capital which took place before the crisis drove excessive consumption and a surge in imports that generated exceptional tax revenues from both VAT and import tariffs. Consequently tax revenues grew even faster than GDP, which itself was growing above trend from 2005 until the onset of the crisis. These above-average public revenues

were (wishfully) thought by policy makers as a normal and permanent feature of the economy. Moreover they were further boosted by large privatization proceeds. Thus, policy makers perceived the low budget deficit, around 2% of GDP, to be a sign that they were following a prudent fiscal policy, while in fact they should have been running a budget surplus. Thus, the underlying deficit that would have corresponded to a normal, and lower, level of tax revenue was actually much higher than anyone realised. In addition the deficit was further increased in those good times by decreases in some tax rates and increases in some items of government expenditure. All these factors placed Serbia in a vulnerable position even before the crisis started.

In 2009, the recession, and specifically the large decline in domestic demand and imports (see Table 1), led to a sharp 8% drop in public revenues, well above the corresponding 3% decrease in output. In accordance with the new IMF attitude, the fiscal policy response in Serbia has been accommodative, i.e. budget deficit was substantially raised to 4.1% in 2009 from less than 2% in 2008. Unfortunately, Serbia could not afford a full increase in the deficit corresponding to a fall in tax revenues (which would have been an anti-cyclical policy), but had to cut some public expenditure in the midst of plummeting demand and output. The reason is that the government did not save by running a budget surplus in the good times to cover the larger deficit which arose in the bad times of the crisis.

The main cuts that have taken place in public expenditure have been in public sector wages and in pensions, which are to be frozen at current levels for two years, from 2009 to 2010. These are the main items of public expenditure, and even in the good times were relatively oversized. Additional expenditure adjustments that were required in 2009 and which were promised to the IMF failed to materialize. Instead, inopportune and unplanned cuts in public investments took place. This is unfortunate, as these investments could have mitigated the drop in demand and output. Moreover, it shows a probable pattern that may re-emerge in the future, namely that warranted public investment could be an easy victim of an ill-planned and half-hearted commitment to large fiscal adjustments.

The accommodative fiscal policy and the consequent increase in the government budget deficit have been carried over into 2010. Due to the sluggish recovery, tax revenues are lower than expected and this has prompted the IMF to accept a higher budget deficit with an unchanged level of government expenditure. Thus the deficit may reach as high as 5% of GDP in 2010, and it could hardly be less than 4% in 2011. These large deficits in three consecutive years are leading to a sharp increase in

public debt, albeit from a very low level. The public debt is still tolerable, at around 35% of GDP, but it has risen by almost 10 percentage points since the crisis started and will carry on rising for some time. Moreover, there is always the threat of hidden debts, while private debts also often spill over into public debt during a crisis period. Therefore the Serbian economy is not yet out of the woods and significant threats to a sustainable recovery remain on the horizon.

Medium term challenges

The above analysis reveals that substantial fiscal adjustments are due in Serbia that should decrease the budget deficit from its current level of 5% of GDP to about 1% of GDP in five year's time. This is an extremely challenging task, first because tax revenue as a share of GDP is bound to decrease as the required rebalancing of the Serbian economy from consumption and imports to investments and exports takes place. In addition, the shrinking tax base (due to falling consumption and imports) with the same tax rates (VAT), while import tariffs are in fact decreasing due to EU accession, will result in relatively lower revenues thus requiring either additional expenditure cuts or increased tax rates. Secondly, the relative decrease in current public expenditure should be even deeper than currently envisaged in order to free up space for essential increases in public investments, but also for the expected larger interest payments on the higher public debt. Although public debt is still moderate, at approximately 35% of GDP, it should be kept under control. This applies especially to the ambitious public infrastructure investments that are envisaged and will need to be financed by heavy foreign borrowings. Moreover, the increase in public debt will also push up Serbia's external debt, which is already high at above 70% of GDP. A recent study by Reinhart and Rogoff (2010) suggests that for emerging markets an external debt above 60% of GDP is associated with a two percentage point reduction in economic growth.

In order to achieve the needed decrease in the government budget deficit Serbia intends to introduce fiscal responsibility legislation that would hammer down the medium term deficit using a set of transitional rules and subsequently help to maintain a prudent fiscal policy stance using more permanent rules. However, significant challenges lie ahead including the expiry of the Stand-by Arrangement with the IMF at the end of 2010 and that approaching pre-election period next year. In all four preceding elections, as documented in the FREN Quarterly Monitor, the budget deficit increased sharply in the period around election time. It is vitally important that this effect should be eliminated or at least significantly reduced in the period before the next elections.

Throughout this crisis, including during the first half of 2010, the exchange rate has substantially depreciated and Serbia has regained much of its international competitiveness. There are some early signs that exports have started to recover and that output has begun to increase, albeit at a modest rate. This all gives some grounds for optimism that the Serbian economy may embark on a sustainable growth path driven at last by increasing exports and investments, rather than as in the past by consumption and capital inflows.

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