External anchors to the rescue: Reaching out in a time of economic and financial sector crises in South Eastern Europe

Jens Bastian

Occasional Paper No. 10/10
February 2010
External anchors to the rescue: Reaching out in a time of economic and financial sector crises in South Eastern Europe

Introduction

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

This conundrum concerned identifying the proximate causes of the economic crisis as well as singling out available policy options to remedy the emerging challenge. As the crisis unfolded and quickly reached the financial sectors of individual countries, key ideological levers in operation during the past two decades started to give way. Praying for the intervention of the Market Gods was not a policy option anymore. Equally, the yearning for the region being de-coupled from the global crisis proved short-lived.

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

Instead of risking to go broke, many countries had to ‘go cap in hand’ to international financial institutions (IFIs); first to Washington (IMF and World Bank), and subsequently to London (EBRD) and Brussels (EU, i.e. EIB). Only through the availability of such a multiplicity of external [financial] anchors did these countries avoid the modern-day equivalent of financial meltdown, namely having to throw in the ‘default towel’.
External anchors such as the IMF, World Bank, EBRD, EU and EIB thus have a critical role to play. The year 2009 has been one of the busiest for such institutions. Through their lending programs they are re-defining a responsibility that consists in sheltering countries in dire need and assisting them in the objective to consolidate their gains after 20 years of complex economic, financial sector and political transition.

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

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

Whatever shape the recovery will take remains a matter of intense debate and forecasting under foggy [weather] conditions. But even if the region’s economies appear to be limping towards a fragile recovery, the willingness and ability of households and businesses to spent freely and receive loans from the banking sector are likely to remain constrained in the medium-term.

**The macro-economic situation**

What is important is the interaction between the ‘real’ recession and the financial crisis affecting the region. Both are reciprocally cause and effect.\(^1\) This correlation has important implications for understanding how long the current recession in the

---

Balkans will last, how deep it will go and what will the exit routes look like. The economic situation as it presents itself at the time of writing (September 2009) casts many imponderables and is rather distant from previous experiences in the region.

Since the onset of the financial crisis in the fall of 2008 the global economic environment continued to worsen in the first quarter of 2009 and appeared to be slightly easing in the second quarter. South-eastern Europe is among the regions most adversely affected, reflecting dramatic GDP contraction\(^2\) (see chart below), sizeable fiscal deficits and numerous external challenges (e.g. current account shortfalls, liquidity problems in foreign currency inflows and declining export capacity).

![Graph 1: Real GDP Performance, 2005 - 2010 in South East Europe*](image)

Source: IMF, World Economic Outlook, October 2009.

The economic and financial crises caught up with the economies of SEE in the fourth quarter of 2008. All countries in the region registered a sharp output decline, with the Romanian, Serbian and Bulgarian economies particularly adversely affected. The

\(^2\) GDP performance, measured in terms of economic activity on the upside or downside, is not the most compelling indicator. G.D.P. represents the sum of domestic economic transactions. It does not however reflect net economic welfare of a given country.
only possible exception to negative GDP performance during 2009 is expected to be Albania and Kosovo (see graph 1 above).³

According to EBRD forecasts from May 2009 GDP contraction will reach minus 3.2 percent for the entire region in 2009. This outlook is less severe than other regions, e.g. Eastern Europe and the Caucasus, but still higher than Central Europe. Such a combined freefall in the economies of the Balkans is only comparable to the initial transition period in the early 1990s (see graph 2).

Source: IMF: World Economic Outlook, April 2009.

When analyzing the reasons for and implications of the global economic and financial crises during 2008-09 it is instructive to note that comparative precedents to this meltdown differ considerably between what was once called ‘the West’ and ‘the East’.

For countries in Western Europe the point of reference most prominently associated with the recent developments is the Great Depression of 1929. But for former

³ By the accounts of the EBRD and IMF Poland is expected to be the only central European country that will possibly avoid negative GDP performance in 2009. Given the size of its domestic market and its fiscal position these two indicators serve as domestic buffers against further GDP decline.
Comecon member countries the historical parallel does not date back that far. Rather it is found in and compared with the collapse of Communism and the initial experiences of economic transition in 1989/90.

The graph on the previous page illustrates that the depth of the current economic meltdown in the region is reminiscent with the onset of economic transformation two decades ago. The economic and financial sector crises constitute the most significant external shock since the beginning of transition two decades ago.

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

Since many of the economies in south-eastern Europe are affected by developments in neighboring countries, there is little reason to assume that Serbia, Romania or Albania have been able to shield their economic performance from GDP contractions in Hungary, Ukraine or Greece.
Migrant workers’ transfers in the Balkans constitute a major economic factor and a key instrument of income generation. As graph 5 underscores, in 2008 remittances as a share of GDP reached 17.4 percent in Bosnia & Herzegovina, 16.6 percent in Kosovo and over 10 percent in Albania. More specifically, the dynamics of remittance flows reflect the evolution of the emerging economic crisis in 2008/09. Remittances slightly increased in the first three quarters of 2008 before starting to stagnate in the last quarter of 2008 and declining since January 2009 in selected countries.4

According to the World Bank, money sent home by migrant workers to their families in SEE countries is set to fall by up to 13 percent in 2009 and the first half of 2010. Such levels of declines have immediate effects on household incomes in the receiving countries. To illustrate: despite a decade of rapid growth, Bulgaria’s average monthly salary of about €300 (USD 420) remains the lowest among EU member states. Moreover, dependence on remittances are critical in a country such as Albania where according to Amnesty International data more than 18 percent of the adult population (over 15 years of age) is estimated to live below the poverty line of USD 2 a day.

The regional impact of declining remittance inflows in south east Europe for 2009/10 is uneven and also influenced by country-specific currency arrangements. Through the depreciation of domestic currencies, non-euro countries such as Albania, Bulgaria, FYR Macedonia, Romania and Serbia will be more adversely affected than Montenegro and Kosovo where the euro is legal tender.

Remittance decline is forecast to recover in the later course of 2010 and 2011 as changes in employment patterns of migrant workers take effect. These changes include sectoral shifts away from construction and manufacturing jobs towards rising employment levels in the hotel, restaurants, wholesale and retail trade sectors that will re-stabilize the inflow of remittances over the medium-term.

4 See also William Lacy Swing, International Organization for Migration, September 2009 and additional data from the Inter-American Development Bank, September 2009.
The flip-side of declining remittances by migrant workers is that the tide of laborers is starting to flow in reverse in Europe. Millions of immigrants from central, eastern and southeast Europe flocked to fast-growing economies like Spain, Ireland, Britain and Greece during the past decade.

But with the deterioration of economies in western Europe, migrant workers from Romania, Albania, Kosovo or Bosnia are not only curtailing their remittances but having to confront the challenge of returning to their countries of origin. As the economic crisis deepens, signs of reverse migration are starting to become evident. This exodus is likely to add to the economic pressures already affecting societies in central, eastern and southeast Europe.\(^5\)

Furthermore, the interest rate differential among southeast European countries and between these and the European Central Bank (ECB) continue to be considerable. As graph 3 below illustrates, the interest rate spreads are considerable, even if they have narrowed somewhat during the past six months. However, these wide margins were a main reason why consumers and corporates increasingly opted out of local

\(^5\) Incentives to leave are not restricted to more prosperous west European countries. The Czech government announced in February 2009 that it would pay € 500 and provide one-way plane tickets to foreign workers willing to return home.
currency borrowing and preferred foreign currency denominated mortgages and loans. The subsidiaries of foreign-owned commercial banks in the region duly obliged and provided such credit facilities at ever growing volumes since the year 2000.

With exports stalling, remittances starting to decline and credit growth slowing, the region of South-Eastern Europe can hardly expect to be in a better position than many other countries in neighboring regions. Sustained current account imbalances incurred during the past decade highlight the dire conditions in which many of the region’s economies find themselves today.

Graph 5 above underscores the magnitude of the economic challenge. Since the beginning of the new Millennium no country in the twin regions of the western and eastern Balkans has registered a positive current account balance. Put otherwise, soaring current account deficits are a reflection of manifest trade imbalances, a preparedness to live beyond a country’s means; with long-term structural consequences for consumers, households and governing authorities. If and when an external economic shock hits countries with such imbalances – as is the case since

Source: IMF: World Economic Outlook, April 2009. 2009 is a forecast, 2010 a projection.
mid-2008 – the adverse effects are immediate and severe, and the necessary adjustments require a painful dose of medicine.

Any economic forecast for the region of South-Eastern Europe (SEE) is currently fraught with considerable skepticism in both downside and upside directions. The best these countries can hope for during 2009/10 are some green shots emerging. But they will have to continue identifying the necessary remedies in order to manage ongoing economic uncertainty and political volatility.

**External anchors to the rescue**

Against this economic background governments and central banks in the region have had to decide how to modify their policies and adjust their toolbox. The IMF dryly observed in April 2009 that “it is important to realize that the global conditions conducive for the previous high growth rates belong to the past”.

In consequence, the imperative has to be that economic, monetary and fiscal policies adjust to these emerging realities. These new challenges spell that both domestic and external budget financing are becoming increasingly scarce. In other words, there is little if any room for new spending initiatives, nor fiscal leverage for implementing stimulus programs. The combination of high C/A and fiscal deficits in economies of south-eastern Europe constitute significant short- to medium-term risk factors beyond 2009/10.

Deficit financing is rather the order of the day, implying that strategic privatization receipts will have to be earmarked towards mandated objectives from IFIs. Furthermore, public sector wages and social transfers are back on the austerity agenda. Otherwise, individual countries risk coming under severe budgetary constraints and liquidity shortfalls, requiring repeated emergency funding from external sources.

International funding institutions such as the IMF, World Bank, EBRD and EU came to the rescue of eight countries in central, eastern and southeast Europe. Between October 2008 and May 2009 they have provided approximately USD 108 billion of

---

emergency lending to Romania, Serbia, Ukraine, Belarus, Hungary, Poland, Bosnia & Herzegovina and Latvia to weather the consequences of the economic and financial crises (see table 1 below). Other countries such as Albania, Bulgaria, Croatia and the FYR Macedonia are currently considering their options.

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

<table>
<thead>
<tr>
<th>Country</th>
<th>Timing</th>
<th>Volume (USD)</th>
<th>IFIs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hungary</td>
<td>October 2008</td>
<td>25.4 billion</td>
<td>IMF, WB, EU</td>
</tr>
<tr>
<td>Ukraine</td>
<td>November 2008</td>
<td>16.4 billion</td>
<td>IMF</td>
</tr>
<tr>
<td>Latvia</td>
<td>December 2008</td>
<td>10.5 billion</td>
<td>IMF + EU</td>
</tr>
<tr>
<td>Belarus</td>
<td>January 2009</td>
<td>2.46 billion</td>
<td>IMF</td>
</tr>
<tr>
<td>Serbia</td>
<td>January 2009</td>
<td>530 million</td>
<td>IMF</td>
</tr>
<tr>
<td></td>
<td>March 2009</td>
<td>4.0 billion</td>
<td>IMF</td>
</tr>
<tr>
<td></td>
<td>October 2009</td>
<td>1.4 billion</td>
<td>Russian Finance Min.</td>
</tr>
<tr>
<td>Poland</td>
<td>April 2009</td>
<td>20.5 billion</td>
<td>IMF (Flexible Credit Line)</td>
</tr>
<tr>
<td>Bosnia &amp; Herzegovina</td>
<td>May 2009</td>
<td>1.3 billion</td>
<td>IMF (Stand-by Loan)</td>
</tr>
<tr>
<td>Romania</td>
<td>March 2009</td>
<td>27 billion</td>
<td>IMF, WB, EU, EBRD</td>
</tr>
<tr>
<td><strong>Total External Funding</strong></td>
<td></td>
<td><strong>110.4 billion</strong></td>
<td></td>
</tr>
</tbody>
</table>


It is important to understand that the financial assistance programs provided by different IFIs and the EU include noteworthy distinctions as regards mode of intervention, volume of assistance and level of conditionalities attached. More specifically, the IMF mainly provides liquidity assistance to individual countries, while the EBRD and EIB can forward capital financing to individual sectors and companies.

This difference not only highlights a significant division of labor between IFIs. It is also the result of these institutions’ varying legal mandates. Notwithstanding these differences in approach and substance, the combination and coordination of these interventions sent a highly symbolic message to international capital and bond markets during the past ten months; namely that east, central and southeast Europe ultimately have a financial safety net that will be extended across the regions!
In three of the eight cases, namely Hungary, Latvia and Romania, the rescue packages have been worked out in close cooperation between multiple international institutions. The IMF, the EU, the World Bank, the EBRD and other multilaterals are contributing to these EU members a variety of financial assistance with different levels of conditionalities attached to the programs.

**The Romanian case**

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

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

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

Romania successfully re-negotiated the terms of reference of its lending program. More specifically, it received permission from the IMF and the EU to run a higher budget in 2009. The revised budget objectives now include running a deficit of 7.3
percent of GDP from the original plan of 4.6 percent in 2009. For 2010 the deficit has to be brought down to less than six percent.

The changes underscore the deepening economic woes in Romania where the global credit slump has decimated domestic consumption, a key driver of economic activity during the past decade. Additional flexibility from the IMF and the EU is deemed necessary because of dwindling state revenues as the Romanian economy plunges deeper into recession throughout 2009 and into 2010.

But even these revised forecasts and agreed adjustments were not enough. In early November 2009 the IMF had to delay access to the third tranche (€1.5 billion) of the bailout loan to Romania while the country continued to struggle to establish a new government. The disbursement was suspended as long as Romania only had a caretaker administration that was not authorized to seek parliamentary approval for a set of conditions in the loan program. In reaction to the IMF’s decision the Romanian authorities alternatively sought a one-year loan totaling €1.42 billion from domestic and foreign capital markets with an interest coupon of 4.25 percent in December 2009.

**The Serbian case**

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

Finally, and for the third time, the Serbian authorities required external financial assistance in October 2009 when they secured a USD 1.4 billion loan from the Russian Ministry of Finance. Serbia is the only country that repeatedly required external financial resources during 2009. It is also the country whose funding inflow

---

7 Romania’s Prime Minister Emil Boc resigned in October 2009 after losing a vote-of-no confidence in parliament. The IMF’s conditions include spending cuts in the public sector, a budgetary law for 2010 and reforms in pension legislation.
has the greatest variety of sources from a variety of international authorities. Positively spoken, this approach could be seen as successfully trying to diversify the country’s funding needs. A more critical reading of the authorities’ actions would question the crisis management rational of decision makers in Belgrade.

These budgetary constraints have immediate effects on public investment capacity and large scale infrastructure projects based on foreign investor arrangements. To illustrate, Vinci Construction, a French building group with big contracts for highway and bridge construction, decided to pull out of Serbia and lay off 3,000 workers because of unpaid bills by the government. More specifically, Vinci Construction’s local subsidiary, Inter-most, filed for bankruptcy in a Belgrade court in April 2009, citing “construction works for public institutions” as the main reason. Government debt to the subsidiary amounted to about €1bn for work already completed.⁸

Losing the confidence of foreign investors is the last thing economies in southeastern Europe can currently afford. The result is a widening fiscal gap and the need to identify emergency funding alternatives from IFIs such as the IMF. But in order to meet the latter’s loan conditions proposals to reduce the size of government expenditure and limit the budget deficit requires politically contentious adjustments which are being contested.

The government in Belgrade was forced to decide against imposing a six percent additional income tax surcharge agreed with the IMF in March 2009 after facing widespread street demonstrations and the threat of sustained industrial action. The tax surcharge was to affect pensions, wages and all other personal income above the threshold of 12,000 dinars (roughly €166 a month).

Labor unions and citizens’ organizations resented taking on the burden of the IMF’s two-year standby credit arrangement with Belgrade while large private sector businesses sought government subsidies. The revised 2009 budget will cut public spending by USD 1.3 billion. Public sector employees’ wages will be reduced between 10-15 percent as well as downsizing employment levels in state administration by 10 percent.

⁸ According to Serbia’s foreign investor council, foreign investors are said to have postponed in 2009 roughly €800 million worth of new investments, see Financial Times, May 2nd 2009.
Can Albania and Bulgaria, Croatia and FYR Macedonia be considered outliers?

As one country after another sought multilateral funding from a combination of IFIs, the growing list also exposed those countries that have yet to come forward. One such country is Albania. The Central Bank governor Ardian Fullani urged the government to turn to the IMF for loans in April 2009. Fullani cited a lack of liquidity in foreign currency inflows as the main reason for recommending approaching the IMF.

However, to date the Albanian government has yet to restore full relations with the IMF. Albania is also an outlier in another respect. It is the only country in the region that does not have a credit rating from any of the international credit rating agencies. The decision to seek assistance from the IMF or not will be taken after the establishment of a new coalition government following the general elections from June 28th 2009.9

In the case of Bulgaria, political and electoral considerations also had an impact on not approaching the IMF before the outcome of the July 5th 2009 general elections. The political sensitivity of the issue during the election campaign prevented the authorities from seeking a financial agreement with the IMF. The amount Bulgaria would need is estimated at ranging between one half and two-thirds of USD 25 billion, the volumes secured from the IMF and the EU by Hungary and Romania.10

Bulgaria’s foreign reserves are shrinking and its gross foreign debt stood at 107 percent of GDP in early 2009. An agreement with both the IMF and the EU would aim to cover the majority of Sofia’s short-term refinancing needs during 2009. How the new government of Prime Minister Borissov will create a publicly acceptable environment for an IMF agreement will be a very delicate balancing act to observe.

The second issue that any new government will have to approach is the debate over maintaining the currency board. Bulgaria’s budget surpluses, accumulated over the

---

9 It took more than three weeks to officially certify the outcome of the vote. The drawn out ballot counting was also a reflection of signs of both improvement and violations during the parliamentary elections. Monitors from the Organization for Security and Cooperation in Europe (OSCE) noted that despite improvements from previous elections, violations and irregularities persisted. The OSCE noted that “procedural violations related in particular to inking procedures and widespread family voting” (IHT, 30th June 2009).
10 How much an agreement with the IMF became a political football during the electoral campaign was exemplified by the leading opposition politician, the Sofia mayor Mr. Boiko Borissov’s party GERB, which argued in favour of a pre-cautionary agreement with the IMF as part of its economic policy priorities.
past years, give the government limited room for fiscal maneuvering. But continued fiscal stability will depend on maintaining exchange rate consistency. Bulgaria’s currency board arrangement that pegs the lev to the euro has proved to be an anchor of stability in the past decade. It has also become the economic cornerstone of a mainstream political consensus.

Speculative pressure on the currency board is increasing, however and officials are closely watching developments in Estonia, Latvia and Lithuania – countries that have also pegged their domestic currencies to the euro.

With a possible devaluation looming in Latvia, the Bulgarian authorities cannot afford to dither over policy options. The macro-economic and fiscal position as well as the state of its banking sector highlights substantive differences in performance and crisis management capacity compared with the Baltics. But this may be lost on investors who see the currency peg as the next exchange rate mechanism set for possible devaluation.

This is where the authorities could find themselves in uncharted territory. Currency devaluation in Latvia could have knock-on effects in other countries with currency board arrangements. Bulgaria claims the currency peg is a tested instrument of crisis management. But the dynamics of the current crisis have shown how difficult it can be to counter contagion.

Any suggestion of abandoning or resetting the peg to the euro would require the international community – most prominently the IMF and the EU - to assist Bulgaria in organizing a controlled devaluation. The big vulnerabilities rest in interest-rate developments, potential liquidity shortages and minimizing adverse consequences for western banks. This is a complex matter. It would neither be cheap nor pain-free.

11 The Latvian economy shrank at an annual 19.6 percent rate in the second quarter of 2009, the second-deepest output slump in the European Union after neighboring Lithuania (minus 20.2 percent). The economic contraction gathered further pace after G.D.P. shrank 18 percent in the first quarter. Only two years ago, Latvia’s economy was the fastest-growing in the E.U. in 2006. Such a turnaround from first to worst in such a short amount of time is unprecedented in the economic history of the E.U.

12 See Jens Bastian, Guest column ‘No time to dither over policy options’, Financial Times, June 18th 2009.
International institutions would have to identify supporting measures in fiscal policy, public sector wages and foreign currency denominated private sector debt in order to avoid the worst outcome – a run on the lev and a disorderly devaluation.

**Is the crisis assistance discretionary, tilted towards EU members?**

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

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

It would be a critical signpost if a new demarcation line is drawn by IFIs for countries in need in the Balkans. How rescue packages are structured according to the needs of the country may essentially depend on a limited set of available alternatives. The IMF, World Bank, EBRD and the EU have the structural depth and critical mass of capital resources to put coordinated rescue programs for the Balkans together. But they may differ among each other in the execution of details or levels of conditionality to be applied.

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

In order to counter-balance this structural discrepancy, and divert the criticism that the EU may appear biased, it has sought alternative financial instruments. In the course of 2009 the EU has started to frontload specific funds for countries in the western
Balkans. More specifically, the EU is using one of its core financing instruments - namely IPA - to deliver funding assistance to non-EU members in the region.13

To illustrate, IPA resources earmarked for capacity building projects are being re-directed as direct budgetary support means. Serbia received €100 million from IPA funds of the European Commission for “general budget support” in July 2009. The Commission noted that such support seeks to “help with the stabilization of the country and ease the economic and social consequences of the crisis”.14

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


This form of EU financial assistance to non-members is based on applying for the first time Art. 15 of the IPA regulations. This clause foresees that in extraordinary circumstances earmarked resources from IPA can be re-directed towards direct

13 IPA stands for Instrument for pre-Accession assistance. It offers financial assistance to countries aspiring to join the European Union for the period 2007-2013. The beneficiary countries are the former Yugoslav Republic of Macedonia, Croatia, Turkey, Albania, Bosnia and Herzegovina, Montenegro, Serbia and Kosovo as defined by the United Nations Security Council Resolution 1244.

14 A further 85 million will be given to western Balkan countries and Turkey to help secure investment in their economies, reform their banking sectors and improve competitiveness.
budgetary support of an EU candidate or accession country or SAP country (Stabilization and Association Agreement).

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

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

Funding will also be granted to the Deposit Insurance Agency in order to enable it to prevent deposit outflows due to the financial crisis. The €39 million were allocated under the IPA envelope for Bosnia and Herzegovina. A second program for the country to ensure continuation of institution-building efforts is expected to be adopted by the European Commission in autumn 2009.15

The Commissions uses such grant funding as a catalyst for additional resources. It is expected to trigger follow-up loan financing from IFIs such as the European Investment Bank, the European Bank for Reconstruction and Development, the German Kreditanstalt für Wiederaufbau (KfW which focuses on small and medium-sized companies and infrastructure projects) and the Council of Europe Development Bank CEB).

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

Is all this enough? Surely not, and it pales in significance when compared to the funding muscle applied by the IMF, World Bank and EBRD. The World Bank’s president, Robert B. Zoellick, joined Austrian officials in August 2009 in calling for more assistance from Brussels to stabilize the region. The WBIF and the EIB’s lending facilities to the region (which totaled €3.2 billion as of December 2008) must be placed in this context.

But the comparison of volumes may in fact be misleading. Rather, we can observe that a division of labor is currently taking place. IFIs are providing large amounts of emergency lending to the western Balkans, with flexible conditionality attached to the rescue programs. By contrast, the EU Commission is supplementing these interventions with limited, but targeted resources allocations, while being much more pro-active as regards the adoption of and adherence to conditionalities for recipient countries.

But this line of (critical) argument about EU initiatives or the lack thereof also has a flip side. In many less direct and visible ways the EU, individual EU countries and the European Central Bank (ECB) have assisted non-EU members in the Western Balkans and Turkey on a far larger scale.\(^{16}\)

For one, the ECB extended its liquidity facility to Hungary’s and Poland’s central banks directly. More specifically, the ECB established temporary reciprocal currency

\(^{16}\)I am thankful to Mr. Panayotis Gavras from the Black Sea Trade and Development Bank in Thessaloniki, Greece for useful arguments in this subject matter.
arrangements to support dollar and/or euro liquidity. In autumn 2008 the ECB agreed with the central banks of Hungary and Poland to support liquidity operations in these countries. However, their gain was neighboring countries’ pains who are not (yet) members of the EU and presently "only" have a stabilization and association agreement with Brussels.

Furthermore, at the G-20 Summit in London in April 2009 EU member countries pledged an additional €100 billion to the IMF, knowing full well that much of these resources would end up in Central, East and Southeast European countries’ stand-by arrangements with IFIs. The ECB has also pumped phenomenal amounts of liquidity into the Eurozone financial systems, and those Eurozone based commercial banks with local subsidiaries and branches in southeast Europe have taken advantage of this window of opportunity and thereby provided liquidity support to their regional holdings. The sums involved were not inconsequential for the continuation of banking operations at a time when money and credit markets had essentially dried up in late 2008, early 2009.

It could thus also be argued that the Commission, the ECB, and EU countries have indirectly been bailing out central, eastern and southeast European financial sectors in a fashion similar to the more direct measures they are taking within the EU/ Eurozone. Eurozone based commercial banks are obviously huge beneficiaries of funding arrangements such as the ECB’s liquidity access programs. Look no further than Greece, where the commercial banks with significant holdings and investments in the Balkans and beyond have obviously (and fortunately) been able to re-finance their operations by taking advantage of accessing various ECB liquidity facilities.\(^\text{17}\)

\(^{17}\) Digressing a bit further, Greek banks have also effectively been intermediaries for the purchase of the enormous amounts of debt issued by the Greek government during 2009. They have been buying up massive amounts and thereby effectively conducting quantitative easing activities.
Financial sector developments in Southeastern Europe

As the countries in SEE are discovering with rising anxiety, the global economic and financial crises were not of their own making. But the economic meltdown in different countries illustrates how their economies can be overwhelmed by their banking systems, most of which are foreign-owned. Confronting this financial sector conundrum cannot be tackled without additional external support, including from International Financial Institutions (IFIs) and the foreign parent banks owning local subsidiaries across south-eastern Europe. The financial bonds that have been built during the past two decades between Europe’s constituent regions created a network of interdependency that is now being challenged at the seams by the economic and financial sector crises.

This requisite multilateral financing was crucial in late 2008 and early 2009 when a growing number of countries needed the rescue option of such external anchors. Equally, as the continuation of an economic downturn scenario across the region is becoming ever more apparent in mid-2009, additional financial assistance cannot be subject to further delays, if and when requested. If it is not forthcoming the emerging situation in the economy as a whole and the financial sectors in specific could result in adverse consequences for individual banks. A looming banking crisis is the last thing any of these economies can currently afford.

The currency devaluations taking place in the region were not the result of any political decision by finance ministries. In other words, they cannot constitute the usual adjustment mechanism in a financial crisis of this magnitude. The debt burden already created for households during the past year’s factual devaluation cannot be replicated by a political decision to use currency devaluation as a crisis management instrument.

The full extent of the financial sector crisis has yet to translate into the real economy. GDP performance and unemployment typical trail adverse developments in the commercial banking sector. Three areas are of particular importance,

(i) credit growth remains conditioned by rising non-performing loans (NPLs) and subsequently the amount of forward-looking
provisioning commercial banks have to include in their balance sheets, thereby binding additional capital resources;

(ii) the ongoing process of bank de-leveraging taking place either in the parent banks’ country of origin, or among their subsidiaries in the region;

(iii) uncertainty over the continued scope and content of external engagement of western parent banks vis-à-vis their local subsidiaries in Southeastern Europe.

In particular the peak in NPLs in the banking sector, which has been rising in every country of the region during the first half of 2009, has yet to fully manifest itself in the real economy. The acuteness of the challenge is illustrated by the following example. Austria-based private Raiffeisen International Bank Holding AG’s second-quarter profit dropped 93 percent. The decline was the result of rising risk provisions for deteriorating loan portfolios in Eastern and Southeastern Europe.

Loan-loss provisions at Raiffeisen International jumped to €524 million from €108 million, reflecting a steep rise in non-performing loans in the first half of 2009, mainly in Ukraine, Russia and Hungary. On June 30th 2009, non-performing loans made up 6.8 percent of the bank’s total credit portfolio, up from 3.7 percent at the end of 2008. The value of loans more than 90 days overdue nearly tripled to almost USD5.2 billion at the end of the second quarter in June 2009 compared with nearly USD2 billion a year earlier.

Similarly, the publicly-owned Bayern LB in the southern German state of Bavaria reported rising risk provisions during the first half of 2009. Eastern and southeastern Europe accounts for two-thirds of total risk provisioning (€ 704 million) for Bayern LB’s loan portfolio. The regional bank has sought to increase market share in countries such as Serbia, Bulgaria, Romania and Hungary through mortgage-lending denominated in foreign currencies and now subject to default and/or non-performance.18

---

18 See Frankfurter Allgemeine Zeitung, 26th August 2009, ‘Momentsaufnahme’.
The potential consequences for individual banks and the wider financial sector are not to be underestimated. Rising NPLs in conjunction with an observed accelerated pace of credit contraction both exert significant burdens on banking institutions in the region. The full extent of mounting NPLs, loan write offs and defaults on mortgages, credit card bills and corporate finance arrangements is yet unknown and a rightly kept secret among commercial banks.

The deepening recession across southeast Europe will turn more such NPLs into bad debts and raise the specter of rising defaults on repayment obligations. It is only a matter of time until this combination of financial sector stress factors filter through into the real economy. Downgrades in the credit ratings of all countries in southeastern Europe during the past ten months reflect international capital markets’ concern over such potential defaults (see table 3 below).

Table 3: Credit Ratings in Southeast Europe December-2009

<table>
<thead>
<tr>
<th>COUNTRY</th>
<th>CREDIT RATING (STANDARD &amp; POOR’S)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Albania</td>
<td>None</td>
</tr>
<tr>
<td>Bosnia &amp; Herzegovina</td>
<td>B+</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>BBB*</td>
</tr>
<tr>
<td>FYR Macedonia</td>
<td>BB</td>
</tr>
<tr>
<td>Montenegro</td>
<td>BB+</td>
</tr>
<tr>
<td>Romania</td>
<td>BB+</td>
</tr>
<tr>
<td>Serbia</td>
<td>BB–</td>
</tr>
</tbody>
</table>

* On Standard & Poor’s watch a triple B credit rating is defined as having adequate capacity to meet financial commitments. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitments. Hence, any credit rating below triple B underlines even weaker capacity to meet financial obligations.

Potential funding problems emerging for commercial banks would immediately trigger further rating downgrades, yield a currency crisis in that given country and a flight of foreign capital. Such a scenario would set off a second wave of sharp output decline, curtailing any upside that may have been in the economic pipeline during the second half of 2009 or early 2010.
Capital flight out of southeast European markets dragged down their currencies substantially over the course of the past ten months. This depreciation has only further complicated efforts of individual countries to refinance their foreign currency debt obligations. To illustrate: Between October 2008 and end-March 2009 the Hungarian Forint depreciated by 30 percent vis-à-vis the Euro. Equally, Serbia’s dinar fell 20 percent against the euro between its peak in August 2008 and April 2009.

Initiatives to support financial sector stability in South-Eastern Europe

Economies in the region are being adversely affected by a dysfunctional financial sector that has relied far too long on foreign currency lending being provided by Western parent banks to their local subsidiaries. Any forecast for the timing and scope of economic recovery in South-eastern Europe structurally depends on the region’s financial sectors to resume lending to private individuals and the corporate sector. Since the beginning of the global financial crisis last year, small and midsize companies have faced a serious credit crunch in all countries of the region.19

It is yet unknown – and therefore anything but reassuring for international capital markets – to what degree commercial banks in individual countries of southeast Europe are starting to register mounting non-performing loans (NPLs), loan write offs and defaults on mortgages, credit card bills and corporate finance arrangements.

The deepening recession across southeast Europe will turn more such NPLs into bad debts and raise the specter of rising defaults on repayment obligations. Moreover, commercial banks will have to increase their loan-loss provisioning in anticipation of rising NPLs, thereby binding additional capital resources. Alarmingly deteriorating loan portfolios of commercial banks from Austria (see above) are a telling indicator.

19 To illustrate, euro-denominated mortgage lending in Serbia, Montenegro, Bulgaria and Romania exploded during the period 2005 until mid-2008, to the point where 85 percent of mortgage debt was held in euros in these countries.
This uncertainty does not only concern west European parent banks vis-à-vis their subsidiaries in southeast Europe. OTP, the largest Hungarian commercial bank, has been very active in the region as an investor during the past decade. OTP pursued an ambitious expansion strategy in central, eastern and southeast Europe, acquiring banks in Serbia, Bulgaria, Russia and Ukraine. OTP’s loan portfolio raises a red flag for investors, especially because more than 50 percent of the bank’s mortgage loans inside and outside Hungary are denominated in foreign currencies.

As the chart on below illustrates, Greek and Austrian commercial banks are most heavily exposed to countries in central, eastern and southeastern Europe. They had the highest share of lending as a percentage of annual GDP of all EU countries in 2008, namely a staggering 76.7 percent and 49.3 percent, respectively.20 Put otherwise, while many competitors initially hesitated, Greek and Austrian commercial banks had the risk appetite to invest early and pro-actively in the region. Geographical proximity mattered for Greece in southeast Europe and for Austria in central Europe. Both countries’ banking sector investments subsequently

---

20 This number would even be higher if the data also included Serbia, Albania and FYR Macedonia, three additional countries where Greek commercial banks implemented a pro-active lending strategy during the past decade. The countries include Poland, Russia, Czech Republic, Turkey, Hungary, Romania, Croatia, Slovakia, Ukraine, Bulgaria, Estonia, Latvia and Lithuania, see Kathimerini, 07.03.2009.
considerably expanded their theatre of operational expansion beyond the initial regional confines.

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

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

Greece’s largest lender, National Bank of Greece (NBG) is present in 12 countries in Southeastern Europe, including Bulgaria, Romania and Serbia. 44 percent of its

---

**Graph 7: Foreign Bank Lending in Central & Eastern Europe 2008**

<table>
<thead>
<tr>
<th>Country</th>
<th>Foreign loans in % of total loans</th>
<th>Foreign lending in % of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Greece</td>
<td>21.9</td>
<td>76.7</td>
</tr>
<tr>
<td>Austria</td>
<td>49.3</td>
<td>70</td>
</tr>
<tr>
<td>Italy</td>
<td>17.5</td>
<td>9.1</td>
</tr>
<tr>
<td>Sweden</td>
<td>26.3</td>
<td>12.4</td>
</tr>
<tr>
<td>Belgium</td>
<td>26.3</td>
<td>9</td>
</tr>
<tr>
<td>Germany</td>
<td>18.6</td>
<td>4.8</td>
</tr>
</tbody>
</table>

Source: Central Banks’ data, Bank for International Settlements, September 2009 and own research.
group net profit in the first quarter of 2009 originated from foreign operations. However, in reaction to challenging market conditions in southeastern Europe, NBG temporarily halted its branch network expansion abroad for the fiscal year 2009. In an effort to contain operating costs NBG’s business focus in the region now rests on organic growth.

Together with all other major Greek commercial banks, i.e. Alpha Bank, Eurobank and Pireaus Bank, NBG did not pay a cash dividend on earnings in 2008. In light of these banks’ participation in the government-financed €24 billion bank liquidity plan in February 2009, any participating financial institutions was legally barred from paying cash dividends for the operating year 2008 to their shareholders.

The chart above further underlines the depth of Greek banks’ exposure (i.e. investments and loans) in the region of southeastern Europe. At the end of 2008, the combined exposure in seven countries of the region (including Turkey) had reached 52.8 billion euro. Broken down into individual countries, such exposure levels reached 28.7 percent market share in Bulgaria, 27.1 percent in Albania and 24.6 percent in FYR Macedonia. Put otherwise, Greek banks are not only heavily invested in the region, but have also become strongly dependent on these countries’ economies returning to short-term stability and long-term viability.
There are further underlying issues that need to be addressed short-term. The credit crunch that is currently affecting countries in southeast Europe follows a decade of excessive loan growth of about 50 percent a year, in particular in mortgage lending denominated in foreign currencies. Between 2004 and mid-2008 the emerging housing bubble in parts of south east Europe was impossible to overlook. Real estate prices doubled in Podgorica, Belgrade, Tirana and Pristina.21

**Cooperation between multi-lateral lenders and commercial banks**

Extending loan guarantees to the real economy and pledging continued support from western parent banks to their local subsidiaries in south-eastern Europe in times of sustained economic meltdown are gradually seeing the light of day. A number of recent policy initiatives highlight the need to identify commercial alternatives to scarce external funding. The focus of these initiatives is to reassure the banks’ customer basis and establish coordinated rescue operations with multi-lateral financial institutions.

Nine foreign-owned commercial banks operating in Romania publicly pledged their continuous commitment to invest in the country in March 2009. Five months later, they followed up this commitment with additional liquidity provisions to their local subsidiaries. In an agreement signed with the IMF they voluntarily agreed to increase the capital ratios of their subsidiaries from the statuary eight percent level to ten percent for the duration of 24 months until mid-2011. In practice, this means boosting their capital by roughly 1 billion Euros as overdue debt rises. Such debt is surging after the domestic currency, the lev weakened 15 percent against the euro in 2009, swelling euro-denominated obligations.

In raising the capital of their subsidiaries and considering other measures to ensure banking stability in Romania, the participating financial institutions seek to re-assure the commitments from parent banks and maintain their overall exposure to the country. Together, the nine banks hold a market share of approximately 70 percent

---

21 This gold rush mentality has come to an abrupt halt. As evidenced by the so-called Real Vienna in May 2009, the most important annual trade fair for corporate property investment in central, eastern and southeast Europe, investment flows into corporate property development only reached €220 million in the three regions during the first quarter of 2009. This level is a decline by two-thirds compared to the fourth quarter in 2008! See *Frankfurter Allgemeine Zeitung*, 28th May 2009.
of total assets in Romania. The banks include Erste Bank, Raiffeisen International and Volksbank (all three from Austria), Eurobank, National Bank of Greece, Alpha Bank and Piraeus Bank (all four from Greece), Unicredit from Italy and Société Générale from France.22

The banks’ public commitment to continue investing and lending in Romania is a welcome initiative. Such joint engagements between financial institutions and the I.M.F. is one of various facilities currently being applied by banks in cooperation with multilateral lending institutions. They testify to the severity of the situation in the financial sector and the need to identify a variety of innovative rescue options in a public-private partnership arrangement.

Table 4: EBRD Capital Support to UniCredit in Central, Eastern, South-East Europe

<table>
<thead>
<tr>
<th>UniCredit (UC) Subsidiary</th>
<th>Lending Facility</th>
<th>Total Volume (million €)</th>
</tr>
</thead>
<tbody>
<tr>
<td>UC Bank (Hungary)</td>
<td>SME Lending</td>
<td>€ 50 million</td>
</tr>
<tr>
<td>Bulbank (Bulgaria)</td>
<td>SME Lending</td>
<td>€ 50 million</td>
</tr>
<tr>
<td>Zagrebacka Banka (Croatia)</td>
<td>SME Lending</td>
<td>€ 50 million</td>
</tr>
<tr>
<td>UC Bank (Serbia)</td>
<td>SME Lending</td>
<td>€ 30 million</td>
</tr>
<tr>
<td>UC Leasing (Serbia)</td>
<td>Leasing</td>
<td>€ 15 million</td>
</tr>
<tr>
<td>UC Bank (Bosnia, Mostar)</td>
<td>SME Lending</td>
<td>€ 30 million</td>
</tr>
<tr>
<td>UC Leasing (Bosnia, Sarajevo)</td>
<td>Leasing</td>
<td>€ 15 million</td>
</tr>
<tr>
<td>UC Leasing (Ukraine)</td>
<td>Leasing</td>
<td>$ 25 million</td>
</tr>
<tr>
<td>Ukrsotsbank (Ukraine)</td>
<td>Tier 2 Capital</td>
<td>$ 100 million</td>
</tr>
<tr>
<td>ATF (Kazakhstan)</td>
<td>SME Lending</td>
<td>$ 70 million</td>
</tr>
<tr>
<td>ATF (Kazakhstan)</td>
<td>Energy Efficiency</td>
<td>$ 30 million</td>
</tr>
<tr>
<td>ATFBank (Kyrgyzstan)</td>
<td>SME Lending</td>
<td>$ 20 million</td>
</tr>
</tbody>
</table>

€ 433 – 517 million*


22 The March 2009 statement argued that “our subsidiaries in Romania will have to adjust to the current challenging economic environment. A need for additional capital cannot be excluded, and will be provided as necessary”. 
A second financial assistance scheme is being implemented by Europe’s main development bank – the EBRD – to extend lending totaling USD 578 million into central, eastern and south-east European subsidiaries of the Italian bank UniCredit. UC is the single largest financial investor and the biggest banking group (by assets) in the three regions.23 The May 2009 agreement with UniCredit is the largest in volume to date. The EBRD also recently extended loans to Banca Comerciala Romana (BCR), a Romanian subsidiary of the Austrian bank Erste Bank.

More specifically, the European Bank for Reconstruction and Development (EBRD) is providing loan finance to UniCredit’s subsidiaries (for a country-by-country breakdown see table on previous page). These loans are not intended to clean up banks’ balance sheets in the eight recipient countries. Rather, they are earmarked to support local branches in extending loans to small and medium-sized companies, enable leasing finance and assist energy efficiency projects. The lion’s share of the USD 578 million will go to UniCredit’s subsidiaries in Ukraine and Kazakhstan.24

During the past months Western parents of commercial banks in the region had come under increasing pressure to reconsider, i.e. curtail their lending facilities to local subsidiaries in the region whilst they receive taxpayer financed bail-out funds in their home countries. The EBRD’s approach is to circumvent this dilemma by targeting specific commercial banks like UniCredit and Erste Bank. By providing medium and long-term debt and equity financing to both institutions the latter can subsequently extend these resources to their subsidiaries for onward commercial lending to corporate entities and projects in Bulgaria, Croatia, Serbia, Bosnia etc.

As these various external funding initiatives illustrate, the EBRD has found a renewed sense of purpose in stabilizing the financial sectors in transition economies. It is also quickly becoming the second-most important lending institution next to the IMF in southeast Europe. Since the beginning of 2009 the London-based Bank increased its planned investments in the financial sector among 30 member

23 UniCredit has a network of over 4,000 branches in 19 countries of central, eastern and south-eastern Europe. Since the mid-1990s UniCredit has invested about €10 billion of equity in the three regions and has approximately €85 billion of total customer loans in the regions.
24 Kazakhstan is suffering a serious financial sector crisis. In April 2009 the largest commercial bank in the Central Asian nation, BTA, announced that it could no longer repay USD11 billion in foreign debt. BTA would only pay interest to foreign creditors. Most major Western banks have loaned BTA money during the past decade. The standstill on repayment of principal does not [yet] constitute a default.
countries by 50 percent, to €3 billion. The EBRD’s President, Thomas Mirow, has asked for an additional USD 14.6 billion from member countries in order to offset the flight of private capital that has made central, eastern and southeast Europe particularly vulnerable to the recent economic turmoil.

The EBRD’s investment is part of a wider crisis response strategy that seeks to implement joint initiatives with the World Bank Group and the European Investment Bank (EIB). The latter announced in May 2009 that it had launched a two-year loan program worth €1.4 billion to assist Serbia with external funding for small and medium-sized enterprises and priority infrastructure projects.

The EIB’s loan facility is earmarked for small and medium-sized enterprises and priority infrastructure projects in Serbia. Together, the three IFIs have pledged over €24 billion in support of the banking sectors in Central, Eastern and Southeast Europe, thereby providing lending alternatives to businesses hit by the global financial crisis.

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

**Does the crisis offer lessons to be learned – and how can they be applied?**

While not of their own making, the economic and financial crises amplify existing reform deficits and expose delays in continuing to implement an unfinished reform agenda in various countries of south-eastern Europe.

As the crisis risks erasing economic and social gains achieved during the past decade, alternative solutions must be identified. This is going to be difficult enough as the closing off of policy options is currently taking shape. Governments across
southeast Europe are increasingly finding themselves in a policy straitjacket. Political and economic decision makers in the region will have to undertake some serious rethinking as to what specific lessons they can learn for the individual constituencies from the global crisis. What conclusions can they draw for the continuation of their transition processes?

It remains to be seen in practice if the crisis can prove to be an effective fillip for overcoming existing reform deficits and delays. In each of the region’s countries the budgets for 2009 are currently being rewritten. No amount of financial hocus-pocus will be able to change the fact that countries in southeast Europe that once thought they could easily borrow their way to prosperity will now have to change course dramatically. Put otherwise, a lasting lesson whose implications have yet to be fully understood is that a credit-fueled economic transition risked leading most countries in the region towards a fiscal abyss without the availability of domestic policy solutions when needed most.25

Cheap (foreign currency) credit and heavy debt loads have dramatically brought home the message that the countries’ attempt to borrow themselves towards market liberalization and financial sector modernization reached a dead end in mid-2008. Many countries in the region are wrestling with acute budgetary crises that have left them unable to refinance their debt obligations and consequently forced them into the arms of the IMF and other IFIs. In consequence, the countries’ choices have narrowed to bad and worse. The last thing the governments in the region want to witness is a default, which could reignite a crisis that appears to be easing.

Any future economic recovery in the region will also have to address the nature and sustainability of the hoped-for recovery. Can they continue to follow textbook neo-liberal policies in banking privatization and market liberalization while their west European neighbors are discussing - and in some cases - implementing the [partial] nationalization of commercial banks?

The financial crisis intersects with the evolving economic crisis in each country of the region. Both challenge the stability of political institutions across southeast Europe. The crisis scenario includes the danger of failed states emerging in central, eastern and southeast Europe. The combination of an economic crisis with uncertainty in financial sector stability overwhelms political institutions in many of the regions’ countries and expose the fragility of its governments.

This crisis assessment has significant foreign policy implications. In various states increasing unemployment and a loss of confidence in the political and economic system threaten to stress test the tipping point of social stability and political cohesiveness. The German Foreign Office warned in March 2009 that the destabilization of the banking system and the devaluation of domestic currencies in southeast European economies risked affecting individual states and groups of states.26

The greatest concern is focused on the development of countries at the edges of the EU, i.e. Ukraine, Byelorussia, the south Caucasus, Serbia, Albania. The crisis assessment includes avoiding a second ‘Island scenario’ as happened in Reykjavik in November 2008 when the banking sector imploded, currency trading was suspended by the central bank, and the government resigned after unprecedented street riots.

As table 5 (below) underscores, the political developments in various countries make plain the pressure the crisis is putting on the institutional capacity of governments. The political consequences of the crisis expose a growing rift inside the various constituencies over how to confront the economic recession and address its social implications.27

---

26 In testimony before the U.S. Congress in February 2009, the U.S. Director of National Intelligence, Dennis Blair, went so far as to suggest that the primary U.S. security concern is now the destabilizing global political fallout from the economic crisis rather than other concerns such as terrorism.
27 Declining voter participation in presidential and general elections across the region is also apparent. In the second round of presidential elections in FYR Macedonia in March 2009 the turnout reached a record low of 40.8 percent. Similarly, the first round of presidential elections in Slovakia registered a record-low participation rate of 43.6 percent.
Table 5: Political Dynamics during the Economic Crisis in Central, Eastern, Southeast Europe

<table>
<thead>
<tr>
<th>Country</th>
<th>Time</th>
<th>Reason</th>
</tr>
</thead>
<tbody>
<tr>
<td>Latvia</td>
<td>February 2009</td>
<td>Resignation of government</td>
</tr>
<tr>
<td>FYR Macedonia</td>
<td>March 2009</td>
<td>Presidential candidate of government elected</td>
</tr>
<tr>
<td>Hungary</td>
<td>March 2009</td>
<td>Resignation of Prime Minister</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>March 2009</td>
<td>Vote of no-confidence</td>
</tr>
<tr>
<td>Montenegro</td>
<td>April 2009</td>
<td>Ruling government re-elected</td>
</tr>
<tr>
<td>Albania</td>
<td>July 2009</td>
<td>Ruling government re-elected</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>July 2009</td>
<td>Government voted out of office</td>
</tr>
<tr>
<td>Romania</td>
<td>October 2009</td>
<td>Resignation of government</td>
</tr>
</tbody>
</table>

What further steps need to be undertaken?

The need for fiscal austerity is without alternatives if governments do not want to lose the IMF rescue option. Other choices such as hoping for an export-led recovery appear to be wishful thinking as long as the key markets for such exports to EU countries continue to contract or stagnate. GDP performance in southeast Europe will critically depend on an increase in the efficiency and competitiveness of the region’s economies. What are the options and constraints currently being discussed within the policy-making community? Three areas deserve special attention in the future, with considerable implications for the management of the financial sector.

I. The role of Central Banks as internal anchors

The critical importance of external [financial] anchors coming to the rescue of numerous countries in central, eastern and southeastern Europe underscores the need for and complementarity of domestic anchor institutions. Key institutions in this context are the central banks operating in the regions.
If anything, central bankers’ responsibility for broader financial [sector] stability has been reinforced by the dynamics of the economic crisis. Their importance during the crisis notwithstanding, central bankers across southeastern Europe will have to come to terms with how fundamentally the crisis has changed both their tasks and their toolkit.

If the economic recovery will be feeble and fragile, their responsibility for the stability of vital markets such as money market operations will only become more acute. Furthermore, the economic damage unleashed by the crisis must lead political leaders and central bankers to reconsider their duties to pre-empt, rather than just respond to potential economic meltdown and financial sector instability across southeastern Europe.

Central bankers in the region will have to ask themselves if they underestimated the extent to which changes in financial structure complicated their task of monetary policy? Authorities in Bucharest, Sofia, Tirana and Belgrade were slow to recognize the full dimensions of the credit crisis. Some additional issues deserving attention concern:

1. The transparency and predictability of central banks’ interest rate decisions will have to receive additional weight during the long march towards economic recovery.

2. How can central bank regulation enlarge the capital base of local subsidiaries owned by foreign commercial banks? Tighter rules on liquidity must be planned for. The Serbian central bank is offering easier capital rules and a liquidity stimulus to all commercial banks that agree to maintain their exposure to the Serbian market unchanged through 2010.

3. Responsibility for macro and micro prudential supervision will have to be included on the policy making agenda of central banks. More specifically, this will also include tools such as margin requirements and maximum loan-to-value ratios.

4. Is there a case to be made to put credit rating into the hands of central bank regulators? Or should the cooperation between such agencies and central banks be put on a new footing?
5. The emerging financial industry in southeast Europe placed too much emphasis on quantitative techniques of analysis and risk management. Re-evaluating collateral requirements, individual credit history and assessing re-payment capacity will herald a much more conservative and hands-on approach by central bank authorities.

Against the nasty backdrop of lower trend growth, high public debt and the risk of both inflation and deflation, the operational environment of central bank authorities in southeastern Europe will remain challenging for years to come. In the course of finding appropriate policy solutions during this extended period their credibility will be severely tested. Central bankers will, in future, have much more discretion and this will influence their mandate.  

II. Revisiting the scope and purpose of taxation

Revisiting the tax administration of each country and the revenue generating capacity of governments implies political risks and costs. But the economic crisis has exposed a gaping deficit in resource availability and allocation when needed most. In order to avoid seeking emergency founding from external [financial] anchors as the means of last and only resort, some unpleasant truths about taxation will have to be addressed. Otherwise, this sort of talk would not spread light.

1. In many countries of southeastern Europe the tax bias favors debt over equity. This predisposition was conducive to extensive borrowing by private households and high leverage ratios accumulated by corporates. The merits of this tax bias need to be reconsidered.

2. On the institutional side of fiscal policy making delicate questions await new answers. How can government tax codes be improved, e.g. by broadening the corporate and personal income tax base?

3. In the past years countries in the region have sought to outdo each other with the adoption of ever lower flat tax regimes. In practice, this

---

28 Continuity in office will be a key factor in this challenging environment. In October 2009 the Romanian parliament re-appointed the long-serving central bank Governor Mugur Isarescu for another five-year term. Mr. Isarescu has been in office since 1990 with a reputation for steady policy-making and a pro-reform stance. He commands widespread respect across the political aisles in Romanian [party] politics.
downward fiscal harmonization severely curtailed government spending alternatives in the medium to long-term. The adequacy of these harmonized tax structures deserves to be reconsidered before thinking about raising taxes. The IMF and the EU have called on countries from the Baltic Sea to the Black Sea to dump their flat tax for more progressive systems.

4. Finally, the medium-term fiscal outlook could also brighten if distortive loopholes (e.g. preferential treatment of housing and foreign direct investment tax breaks) are curtailed or altogether eliminated. Other fiscal priorities will vary from one country to the next.

III. Regional Cooperation – Regional Ownership

The crises’ consequences also initially highlighted a remarkable absence of any signs of solidarity, joint policy initiatives and crisis coordination between governments and central banks in Southeast Europe. Only belatedly are joint meetings of central bank governors from the region taking place. Finance and/or economics ministers in south-eastern Europe have started to convene and thus send out the message that their individual problems may include joint solutions, or at the very least common policy recommendations.

The question that springs to mind is if policy-makers could extract more comprehensive solutions from IFIs and the EU if they would form an [informal] alliance with each other. Is the formation of a Balkan entente too much to ask for under these extraordinary circumstances? The clarion call for increased regional cooperation between southeast European countries should rest on an attitude of self-confidence and cooperative interaction.

Instead, they are currently competing for limited external emergency funding. Furthermore, they appear as rivals in the process. More specifically, in the absence of joint policy responses the crisis pits new EU-member states vis-à-vis non-member states from central, eastern and southeast Europe. They are becoming competitors in areas such as external funding, FDI inflows, corporate taxation levels and lending resources from commercial banks.
For over a decade countries in southeast Europe have been in an inferior economic power position vis-à-vis their central and most eastern European neighbors. In order to put forward their demands and requirements they will seriously have to consider joining forces. A historic reference may illustrate the advocacy of such regional cooperation initiatives. In the early 1990s the term Visegrad countries was coined to identify a group of countries who pledged to undertake joint policy initiatives in the spheres of policy making, economics of transformation and European integration.

In the case of central Europe, only the Hungarian Prime Minister Ferenc Gyurcsány took up the banner for a regional bailout by Western countries of troubled eastern European economies. His January 2009 proposals for a €180 billion bailout for the region met few allies and left Gyurcsány looking politically isolated and Hungary economically weak. He was forced to resign shortly thereafter.

To date the advocacy of a Balkan cohesion fund has not been circulated in any capitals across the region. Is the absence of such an advocacy and the rather hesitant calls for joint policy initiatives a reflection of non-existing political determination? Or does the formation of such common institutional causes require that some neighboring country or institutional arrangement would need to be in the driver’s seat to kick-start such an initiative? The newly established Regional Cooperation Council (RCC) has so far not been able to step up and lead the way. The RCC could and should seek to coordinate crises responses in the region, initiating common approaches and advocating joint policy recommendations on behalf of neighboring Balkan partners.

The emphasis on these issues and challenges is most welcome and necessary. Obviously, that laundry list does not in itself constitute a comprehensive blueprint for reform. It will not solve the region’s economic problems and structural deficits

---

29 The Visegrad countries included Poland, Hungary the Czech Republic and Slovakia.
30 75 years ago Greece, Turkey, Yugoslavia and Romania signed the so-called Balkan Entente. This agreement sought to protect the signatory countries from internal conflicts and European antagonisms. Despite its demise during the Second World War, the entente was a unique effort by these countries to take political matters into their own hands instead of being manipulated by actors outside the Balkans. The French Institute in Athens organized a conference in May 2009 in the Greek capital to commemorate the signing 75 years ago and inquire if such an Entente Balkanique could offer new perspectives for south east Europe.
quickly. The chances of sustainable recovery without external assistance appear small indeed. There is more work to be done and the region’s countries will need additional external resources.

As the real economies in southeast Europe are being hit by the second and third waves of the financial crisis, they will have to confront a widening set of economic problems. But this confrontation will have to go hand-in-hand with the identification of and contribution from improved domestic anchors, be they financial, regulatory or institutional.

Three possible scenarios

Let me begin with the worst case scenario, economic apocalypse. It goes as follows: While the global economy gradually regains some footing during 2009, the recovery is sectorally uneven and geographically limited. The region of southeast Europe does not benefit from this initial, piecemeal recovery, with adverse consequences on currency developments, treasury bill placement and banking sector liquidity in selected countries such as Bulgaria, Romania, Serbia and possibly Montenegro.

Because southeast Europe’s banks are mostly owned by Western parent banks, [justifiable] fears of banking sector insolvency spread into the bond and credit markets and raise anxieties over potential government insolvency throughout the region and in neighboring countries such as Hungary, Ukraine and Greece. The consequences of such a worst case scenario are difficult to predict altogether. We would rather have to fasten our seats belts while entering uncharted territory.

Nobody thinks this scenario is likely, but quite a few people are willing to admit that it is possible.31 The instability of individual countries and its potential for spill over effects into others even amid a general nascent rebound was highlighted in early October 2009 when an auction of Latvian treasury bills failed to attract any bidders. The failed auction increased the likelihood that Latvian would have to devalue its currency while roiling Scandinavian currencies and putting pressure on the Bulgarian currency board.

The intermediate scenario, ‘no panic, just gloom’, is less dire, but with various strings attached to it. The economic downturn in the region of South-eastern Europe continues to be nasty. But due to a series of contentious domestic policy changes and coordinated outside intervention economic contagion can be averted during 2009-10. The IMF, in cooperation with the EBRD, World Bank and the EIB continues to pro-actively seek country-specific rescue programs. These joint initiatives target lending facilities for the commercial banking sector and small and medium-sized enterprises.

Domestically, despite considerable political opposition over their social implications, a combination of fiscal tightening, strict monetary policy and expenditure cuts (infrastructure projects, pensions, public sector wages) support foreign emergency assistance and help stave off the worst. However, over-indebted consumers must rebuild their savings, while budget deficits remain large.

This baseline scenario implies that the private shift to thrift and dwindling public resources severely limit investment capacity in the coming years. The real questions concern the medium term. How much damage will greater indebtedness do to economic growth perspectives and governments’ creditworthiness?

Finally, the crawling near the bottom, thin ice scenario suggests that the region as a whole will not be able to return any time soon to sustainable economic growth. Individual countries will fare better than their peers. However, the short-term political costs and medium-term social ramifications of this uneven economic development will be considerable.

In the financial sector, the region will avoid that west European banks pull out. But these parent institutions will alter their investment priorities, in particular with respect to lending volumes and as a result of revised risk [management] assessments. This conservative approach will make the availability of foreign currency loans more difficult and curtail banks’ leverage. Yearly growth rates in lending of 40-60 percent belong to the past! Moreover, foreign lending institutions will have to keep a close eye on the development of non-performing loans and
complimentary provisioning requirements, putting a brake on their profitability outlook for the region.

All told, the outlook is challenging to say the least. Whatever the outcome in the coming months, any of these three scenarios may contain bits and pieces of the economic puzzle that is being re-arranged in the Balkans. In some countries of the region, namely Serbia, Romania, Bosnia and Montenegro, the economic and financial crises has badly damaged the public finances. All this is daunting enough. But for a full sense of the task facing governments, institutional deficits in crisis management capacity have to be added to the crisis-related damage.

Until the region’s economies have arrived at what economists call “a logical inflection point” they will continue to struggle with liquidity problems and potential threats emanating from their financial sectors. Southeast Europe is seeking to reach that point of reference with sustained and coordinated assistance from IFIs. But they also have to acknowledge that their economies and financial sectors still have several years’ worth of problems ahead.

**Exit strategies or shaping the reform agenda? The future role of external anchors**

The current challenges of the region defy easy categorizations and comparisons. Are the economies in south east Europe now discovering their limits, i.e. the limits of autonomous economic development, constraints of financial sector integration and the restrictions of crisis management when confronted with the magnitude of such an economic downturn? These are questions searching for new answers. Governments and civil society face a major task ahead to identify what lessons can be learned, and must be applied, from the economic calamity 20 years after the events of 1989/90.

This task will have to include re-tooling existing policy responses. As the developments since mid-2008 have shown in the region, crisis management and policy solutions lagged behind the unfolding dynamics of economic events. Equally, the nature of the responses that have since been formulated with the coordinated assistance of the international community may lead various actors involved to re-appreciate - and revisit - the notion of *political economy*. 
The EU Commission in cooperation with numerous IFIs has mobilized unprecedented levels of emergency lending programs and grant facilities in order to confront the short-term needs of the region. But the Commission, IMF, EBRD, World Bank, EIB, CEB and other bilateral donors are just starting to recognize what will need to be done medium-to long-term over and above the provision of financial resources. Issues deserving attention in Belgrade, Bucharest, Tirana, Sarajevo and Skopje concern:

1. On what growth model should future economic development be based? GDP performance resulting from credit booms, excessive household and corporate debt as well as over-reliance on foreign capital inflows and unsustainable current account deficits has fundamentally been called into question.

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

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

4. External anchors coming to the rescue of countries severely hit by the economic downturn in the region cannot extend these levels of lending much longer. They will have to engage in winding down exercises and identify gradual exit strategies from these programs. This strategy will considerably test the capacity of domestic anchors to complement and over time replace the activities of external [financial] anchors.
Handling issues such as figuring out exit strategies and/or capital increases is delicate. Discussing such strategies now may spook markets and policy makers that measures could be withdrawn too quickly and thus undermine the recovery. But the same holds vice versa. Being silent about winding down exercises runs the risk of encouraging markets and authorities in the region to become complacent, thinking IFIs will stick with lending programs and grant facilities too long.

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

Moreover, the EBRD has appealed to member states for an extra €10 billion to lift its capital by 50 percent³² to mitigate the impact of the global economic crisis on central and eastern Europe. The request seeks to allow the EBRD to expand its lending and compensate for the sharp decline in private capital flows into emerging European markets. The need for a capital increase also underscores concerns that the region’s economic and financial sector difficulties are far from being overcome.

If the EBRD would continue to operate with its current €20 billion capital, the Bank would have to limit its annual lending to a record €8 billion in 2009-10 and reduce it to €6 billion thereafter. The €10 billion capital increase would allow the EBRD to commit €10 billion annually, or €20 billion in total extra funding in 2010-15. By mobilizing extra capital from private investors, the total additional funds raised could reach €60 billion.

Such an unprecedented capital increase by the EBRD underlines how precarious any economic recovery in the region is viewed by lending authorities in London and beyond. Moreover, the depth of the global recession and the funding needs expressed by IFIs such as the EBRD illustrates to what degree the downturn is

---

³² The additional capital would consist of €1 billion that would be paid in by the 61 government shareholders, including EU countries, the U.S.A. and Japan, and €9 billion in callable capital. The capital increase will be voted by shareholders at the next annual meeting of the EBRD in May 2010.
transforming such institutions. Before the crisis struck the Bank’s countries’ of
operation, the US, the biggest shareholder, was keen to reduce the bank’s activities
on the grounds that its funding role in supporting post-communist transition was
nearing the end as market economies were taking root.

But the economic crisis has reduced the amount of private capital available across
the region. The EBRD, along with other IFIs reacted by increasing its own resources,
thereby extending the development bank’s lifespan and *raison d’être*. In a word, the
EBRD’s job is far from ‘mission accomplished’ from the Baltic Sea to the Black Sea.

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

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

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

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

(i) individual countries seeking immunity from economic and financial sector vulnerability,

(ii) adopting Asian style self-insurance strategies.

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

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

Two recent developments underscore the importance of re-vitalizing the EU magnet. For one the EU visa liberalization regime coming into force for citizens from Serbia, Montenegro and FYR Macedonia in December 2009. The other key development concerns the EU Commission’s decision to unblock the so-called Interim Agreement with Serbia. This unblocking opens the door for the implementation of the Interim Agreement by all EU members and paves the way for Belgrade to submit its formal membership application in mid-December 2009 before the Swedish EU presidency comes to a close.\footnote{The EU’s continued power of attraction is mirrored by Albania’s and Montenegro’s membership applications in April 2009 and December 2008, respectively. Iceland’s application in September 2009 adds a new dimension to the EU enlargement agenda.}
Conclusions

The region of southeast Europe now finds itself in the early and volatile stages of what could be an economic recovery, or an intermission before a renewed downturn. Before rushing to any optimistic outlook or worst case scenarios, a word of caution is in order. Since many macro-forecasters got it wrong in the past, prudence about any economic outlook for the region is appropriate and rather a sign of considered reflection.

The IMF’s October 2009 World Economic Outlook report argues that banking crises usually leave “long-lasting scars” on countries, knocking an average 10 percent from output per capita. The report warns that losses in capital, employment and productivity following banking crises could leave “an enduring imprint on the productivity of these economies”.34

The rate of economic contraction in the region is slowing down. Technically, most countries may be moving out of recession in 2009/10.35 At this stage it is pure speculation if the nature of any recovery will be L, W, U or V shaped in the region’s economies. The coming months are still going to feel very much like a recession to many constituencies across southeastern Europe. In the next years the trend growth rate of most countries in the region will be much closer to 2–4 percent than in the vicinity of 5–8 percent as during the past five years.

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

35 According to the EBRD’s May 2009 GDP forecast in 2010, Bosnia & Herzegovina and Montenegro are expected to continue registering economic contraction next year. The IMF estimates that the Latvian economy could end up shrinking by 18 percent in 2009 while Ukraine’s could decline by as much as 14 percent.
The region remains vulnerable to a renewed slowdown in the global economy, what economists call a ‘double-dip recession’. To illustrate the severity of the challenge: the Bulgarian economy fell into an even deeper recession in the third quarter 2009. GDP contracted an annual 5.8 percent compared to Q3 in 2008 after shrinking 4.9 percent in the second quarter 2009.

In addition, concerns about the medium-term solvency of governments will soon appear on the radar. In light of their heavy borrowing from IFIs in 2008/09 and possibly beyond, countries such as Romania, Serbia and Bosnia & Herzegovina will face re-payment obligations that severely restrict their fiscal policy making options in the coming years. While the short-term fiscal pain is considerable, the long-term mess and necessary adjustments that lie ahead are complex and uncertain.36

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

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

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

36 While this contribution focuses on the economic crisis, much deeper consideration has to be given to structural factors such as demographics across the region. The fiscal costs of an ageing population in combination with an ever-younger labor force without active employment prospects is a social and fiscal challenge further compounding the current economic conditions in most countries of the Balkans.
In light of what has happened, the trajectory ahead for the countries in southeast Europe lacks a clearly marked road map. But what is becoming more obvious by the day is the following: the current import-led, financial sector driven and debt-fuelled transition trajectory of economic development in the region is subject to root and branch re-evaluation.

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

(i) the identification and creation of additional fiscal space,
(ii) their crisis management / reaction capacity and regulatory expertise,
(iii) financial sector regulation, in particular regarding foreign currency lending.

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

This is a time for new ideas, bold thinking and original perspectives. Economic reformers are going to have to make some hard choices about the degree of disappointment they’re willing to live with in societies of south east Europe. Thought-provoking choices about the nature of their political economies lie ahead and need to be re-considered in the region.
About the author

Dr. Jens Bastian is currently collaborating with ELIAMEP in Athens, Greece in the capacity of Senior Economic Research Fellow for Southeast Europe. He is Managing Editor of the Journal of Southeast European & Black Sea Studies. Between 2005 and end-2008 he was Economist/Institution Building at the European Agency for Reconstruction in Thessaloniki, Greece. He has worked as a Senior Investment Analyst for the private sector Alpha Bank in Athens between 1998 and 2005. Prior to his engagement with Greece he was DAAD Lecturer in the Political Economy of Transition at the London School of Economics from 1994-1998. He received his PhD from the European University Institute in Florence, Italy in 1993.
South East European Studies at Oxford (SEESOX) is part of the European Studies Centre at the University of Oxford. It focuses on the interdisciplinary study of the relationship between European integration and the politics, economics and societies of the Balkans, Greece, Turkey and Cyprus. Drawing on the academic excellence of the University and an international network of associates, it conducts policy relevant research on the multifaceted transformations of the region in the 21st century. It follows closely conflict and post-conflict situations and analyses the historical and intellectual influences which have shaped perceptions and actions in the region. In Oxford's best tradition, the SEESOX team is committed to understanding the present through the longue durée and reflecting on the future through high quality scholarship.

SEESOX has the following objectives:

- To support high-quality academic and policy-relevant research on South East Europe;
- To organise conferences, workshops and research seminars;
- To promote multi-disciplinary study of the region's development within Oxford University (e.g. politics, international relations, law, sociology, economics) working in collaboration with other Centres and Programmes within the University, including student societies;
- To spearhead intellectual exchanges and debate on these issues among networks of individuals and institutions beyond Oxford;
- To foster cooperation between the academic and the policy making communities.