

The Variable Impact of the Global Economic Crisis in South East Europe

Will Bartlett

London School of Economics and Political Science

Ivana Prica

University of Belgrade

Published by

LSEE - Research on South Eastern Europe

Managing Editor

Ioanna Antonopoulou

Reproduction and Printing

Reprographics, LSE, April 2012

Cover Photo

Filip Prica

Table of Contents

1. Introduction	01
2. The Global Economic Crisis: Impact on South East Europe	04
3. Transmission Mechanisms and Domestic Structure	08
4. Institutions	17
5. Policy Responses	24
6. Conclusions	30
References	35

Acknowledgements

An earlier version of the paper was presented at the Managing Economic Transition (MET) network 24th Research Seminar on “Crisis in Transition” in Brighton UK on 8 January 2010, and at the EACES Workshop on “Market Failures and the Roles of Institutions” held in Milocer, Montenegro, 22-24 September 2011. We are grateful to Vassilis Monastiriotis and to participants at the two meetings for helpful comments on earlier drafts of the paper. The responsibility for any errors or omissions is however entirely our own. The paper has been previously published in *Economic Annals*, Vol LVI, No. 191, pp. 7-34. We are grateful to the editors of the journal for permission to republish the paper in this series.

About the Authors

Will Bartlett is Senior Research Fellow in the Political Economy of South East Europe at the LSEE research unit at the European Institute, LSE. He holds a PhD in Economics from the University of Liverpool on unemployment in the former Yugoslavia, an MSc from the School for Oriental and African Studies and an MA from the University of Cambridge. His research interests cover aspects of economic and social development in South East Europe. From 1983-1986 he was Research Fellow at the European University Institute in Florence, Italy. He has worked as a senior economic advisor to the European Commission in Kosovo and on numerous research and consultancy projects in the region funded by the ESRC, the Leverhulme Trust, the British Academy and the European Training Foundation. His book “Europe’s Troubled Region: Economic Development, Social Welfare and Institutional Reform in the Western Balkans” was published by Routledge in 2008. He has been President of the European Association for Comparative Economic Studies and holds Honorary Professorships at the School for Policy Studies, University of Bristol and at the London School of Hygiene and Tropical Medicine.

Ivana Prica is Assistant Professor at the Faculty of Economics in Belgrade, where she teaches economic modelling and marketing research. She holds a PhD in Economics focusing on financial services liberalisation in Central and Eastern Europe. Her research interests are in the economics of international trade and global finance. From 2001-2005 she worked as senior economist on a USAID funded project advising the Serbian government on trade liberalisation and WTO accession. She has also worked as a consultant to the WTO and from 2008-2012 she worked as a senior economic advisor for several European Commission-funded projects in Bosnia and Herzegovina and in Montenegro. She has published widely in both Serbian and English languages on trade in services, financial liberalisation and the impact of the global financial crisis in South East Europe. She received the Best Undergraduate Student Award of the Faculty of Economics, Belgrade in 1990 and was awarded a TEMPUS scholarship to study at the LSE in 1991-92.

The Variable Impact of the Global Economic Crisis in South East Europe

Will Bartlett and Ivana Prica

1. Introduction

This paper studies the variable impact of the global economic crisis on the countries of South East Europe¹. This group of transition economies, as elsewhere throughout Eastern Europe, has been severely affected by the recession (Prca and Uvalić 2009). However, while some countries within the region have been deeply affected, others appear to have been relatively lightly touched by the crisis so far. What factors could account for this variation in outcomes? In so far as the countries of the region experienced a common external shock, it would seem that the differential responses must have been conditioned by between-country differences in initial conditions at the start of the crisis. In this paper we investigate the role of the two key sets of initial conditions (i) the role of differences in institutional frameworks which were developed during the earlier period of transition and (ii) the role of differences among the countries of the region in their degree of integration into the world economy.

¹ The following countries are included in South East Europe: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia, Greece, Kosovo, Moldova, Montenegro, Romania, Serbia, and Turkey. The main focus is on the transition economies, and Greece and Turkey are included as comparators.

Considering the role of the institutional framework developed during the transition, Mitra et al. (2010) ask whether the transition itself planted seeds of vulnerability that made the transition countries more prone to crisis and limited the ability of transition economies to recover from it. A more optimistic view of institutional reform suggests that countries that have made more progress with transition and have built better institutions supportive of a flexible market economy would be better able to adjust to the impact of an external shock; this could account for the variability in the impact of the crisis on economic performance. This view which stresses the link between progress with reforms and economic performance has become the conventional wisdom (see for example EBRD 2008). There is also a possibility of a reverse feedback from the crisis to institutions through its effect on progress with economic reforms. In some cases the crisis may block progress, while in others it may even speed it up (EBRD, 2009). Several types of institutions determine the degree of flexibility of an economy including the extent of EU integration, progress with transition, the business environment and the quality of governance, as will be discussed further below.

In contrast, it could be argued that the institutional framework is irrelevant and that variability in the impact of the crisis is simply due to the fact that countries that are less integrated into the global economy have been less affected by it and vice versa. This argument emphasises that the effects of crisis were transmitted through a decrease in demand from the EU core countries to the European peripheral countries. It suggests that variability in exposure to demand for exports and migrant labour, in access to credit, and in inflows of foreign investment and remittances have been the main cause of the differential impact of the economic crisis in the region.

There are consequently several possible explanations for the variable impact of the economic crisis on the countries of the region. Firstly, differences in the initial structural conditions provide different exposure to different transmission mechanisms from the external environment. For example, countries that have a larger export industry and a larger share of exports in gross value added may be more exposed to falling demand for exports than others. Secondly, differences in the initial institutional conditions due to transition reforms may have provided different exposure to the transmission mechanisms. Those countries that have made more progress in institutional reform and have developed better market mechanisms may have been better able to adjust to the impact of the external shock than others, and vice versa. Thirdly, the economic policies of domestic governments and international institutions may mitigate or worsen the impact of the adverse external environment. In this paper these various influences are examined in turn.

Section 2 provides an overview of the effects of the crisis in the SEE region, section 3 identifies the variable extent of the transmission mechanisms across countries, taking into account credit contraction, foreign direct investment, remittances and exports and their interaction with domestic structural conditions. Section 4 considers the role of institutions in moderating the effects of the crisis taking into account progress with EU accession, progress with transition, and the quality of governance. Section 5 considers the impact of domestic and international anti-crisis policies in mitigating the effects of the crisis. Section 6 concludes.

2. The Global Economic Crisis: Impact on South East Europe

The sharpness of the contraction in SEE is underlined by data for real GDP growth for 2009 – 2010, along with data on the change in an index of industrial production for 2008-09 and the increase in the unemployment rate, in percentage points, for the period 2008-2010. In the analysis that follows we use the change in GDP as the main indicator.

TABLE 1: Change in real GDP and industrial production (% p.a.)

	Real GDP growth (% p.a.)				Change in industrial production (% p.a.) 2008-2009 (a)	Increase in unemployment rate in percentage points (LFS data) 2008-10 (b)
	2008	2009	2010	Average 2009 - 2010		
Albania	7.7	3.3	3.0	3.2
Turkey	0.7	-4.7	8.0	1.7	-9.7	0.9
Macedonia	4.8	-0.8	0.8	0.0
Serbia	5.5	-3.1	1.6	-0.8	-12.1	5.2
Bosnia and Herzegovina	6.0	-2.8	0.8	-1.0	1.5	3.8
Bulgaria	6.2	-4.9	0.4	-2.3	-17.4	4.6
Moldova	7.8	-6.5	1.5	-2.5
Montenegro	7.5	-5.7	-0.6	-3.2	-31.9	..
Greece (a)	1.0	-2.0	-4.5	-3.3	-9.0	4.9
Slovenia	3.7	-8.1	1.1	-3.5	-17.3	4.6
Croatia	2.4	-5.8	-1.5	-3.7	-9.2	3.4
Romania	7.3	-7.1	-2.0	-4.6	-5.5	..

Source: EBRD online data; (a) Eurostat online data; (b) CPESSEE (2011)

As can be seen from Table 1, Albania and Turkey have weathered the crisis rather well, with the latter pulling out of recession with a rapid 8% GDP growth in 2010. A second group of countries in the Southern

Balkans (Bosnia and Herzegovina, Macedonia and Serbia) had relatively high pre-crisis growth. They experienced only a moderate decline in 2009 followed by a modest growth in 2010 giving an average growth for 2009-2010 of between 0.0% and -1.0% of GDP. A third group of two countries including one EU member state (Bulgaria and Moldova) had relatively sharp declines of between -5.4% and -6.0% in 2009 followed by modest recoveries in 2010 putting the overall growth for the two years between -2% and -3%. The final group comprises Croatia, Greece, Montenegro, Romania and Slovenia all of which with the exception of Slovenia had two years of negative growth with declines of between -2.0 to -8.1% of GDP in 2009 giving an average decline for 2009 and 2010 in excess of -3% of GDP. Slovenia ends up in this group because of its very sharp contraction in 2009 followed by a feeble recovery.

In most countries, industrial production and exports fell even more precipitously than GDP. In Montenegro, industrial production fell by a staggering 32% between 2008 and 2009². Double digit falls in industrial production were registered in Bulgaria, Serbia and Slovenia. Export values fell by more than 20% in all the countries in 2009. Labour Force Survey data show that between 2008 and 2010 the unemployment rate increased from 23.4% to 27.2% in Bosnia and Herzegovina, from 14% to 19.2% in Serbia, from 8.4% to 11.8% in Croatia and from 4.4% to 7.3% in Slovenia.³ The crisis has also had wider social impact increasing poverty and lowering the quality of life for people throughout the region (Bartlett 2010).

² According to Eurostat industrial production statistics online data March 2011

³ See CPESSEE (2011)

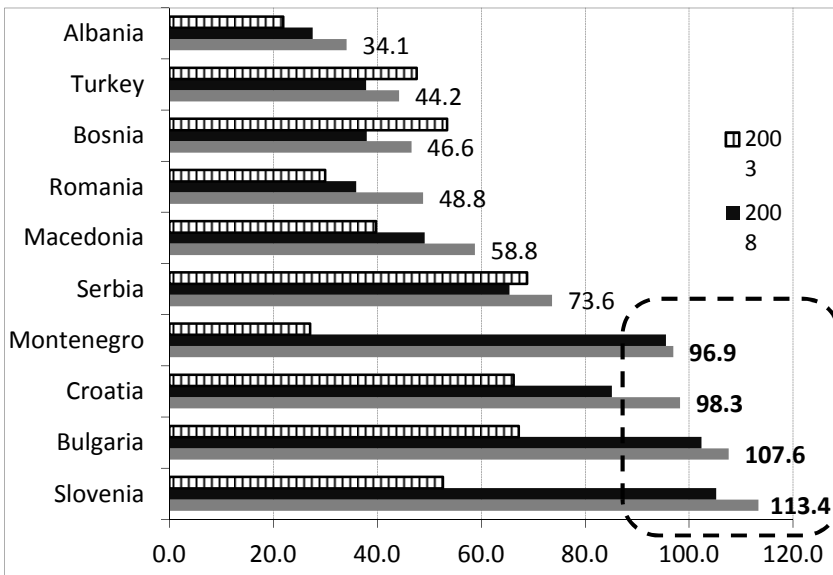
BUILD-UP TO THE CRISIS

In the period between 2000 and 2008 the economies of the SEE region had enjoyed a mini-boom, mainly been fuelled by large inflows of international finance in the form of bank credits enabling increased domestic borrowing by both firms and households. While government expenditure had also grown, in many countries it had been kept in check due to the success of the IMF and the EU in persuading governments to keep a lid on spending. Rapid growth spurred an increase in imports which, in the context of relatively uncompetitive economies, led to increased current account deficits despite significant remittance flows in some countries. Current account deficits became extremely high in Montenegro (50.7% of GDP in 2008) and Bulgaria (23.9%).

Thus, most countries in SEE had based their growth since 2000 on a credit boom enabled by large scale foreign borrowing. Current account deficits widened to more than 10% of GDP in 2008 everywhere except in Croatia, Slovenia and Turkey. In 2008, extremely high current account deficits were experienced in Serbia (17.9%), Bulgaria (23.9%) and Montenegro (50.7%). While this would be an acceptable way to finance economic growth if the resources were shrewdly used for investment, the reality was that in many cases there was a large element of consumer boom involved, while in the case of Bulgaria and Montenegro property bubbles also underlay the rapid growth in financial inflows. The current account deficits were covered by large capital inflows including foreign borrowings that led to an increase in the ratio of external debt to GDP in most countries (see Figure 1). Five countries, Albania, Bosnia and Herzegovina, Moldova, Serbia and Turkey experienced moderate or even negative growth in their external debt to

GDP ratio over the six years from 2003-08.⁴ In 2009 these countries managed to keep their external debt down to below 60% of GDP. However in four countries, Bulgaria, Croatia, Montenegro and Slovenia, the ratio of external debt to GDP exceeded 90% of GDP in 2008 and 2009, exposing them to difficulty in refinancing their debts. The most rapid growth in external debt occurred in Montenegro whose debt increased from 27% of GDP in 2003 to 97% in 2008.

FIGURE 1: External Debt to GDP Ratio (2003, 2008, 2009) (%)



Source: EBRD online data 2011

⁴ Bosnia and Herzegovina's external debt had even fallen from 54% of GDP in 2003 to 38% in 2008.

3. Transmission Mechanisms and Domestic Structure

Four external transmission mechanisms relayed the economic crisis from the centre to the SEE region. Firstly the mainly foreign owned banking sector transmitted the collapse in global credit flows to SEE. Secondly, there has been a sharp reduction in inflows of foreign direct investment which has hit some countries harder than others. Thirdly, reduced demand for labour in the core market economies has had a dramatic effect on remittance flows on which some SEE countries are heavily dependent. Fourthly, reduced global demand for imports significantly impacted on the exports from the SEE countries.

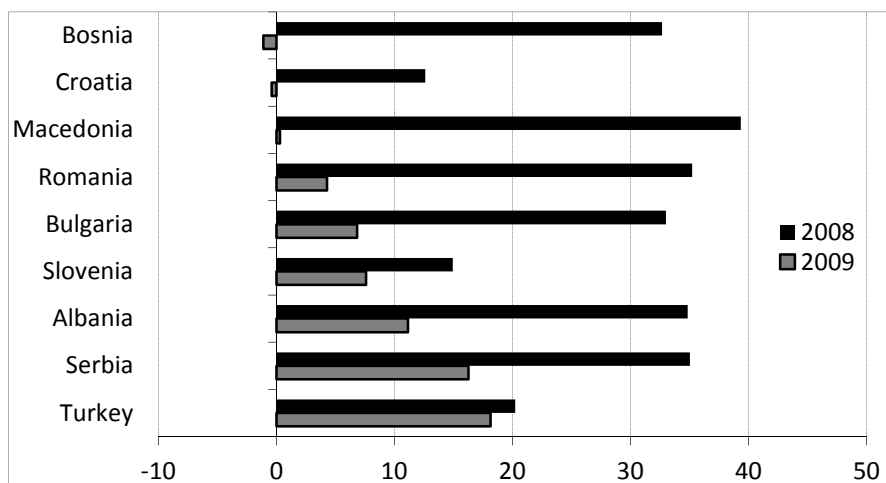
THE BANKING SECTOR AND CREDIT GROWTH

An important transmission mechanism has been the global restriction of credit which has especially affected transition economies with a high penetration of foreign banks (Milesi-Ferretti and Tille, 2011). Over the last decade, foreign banks have been eager to establish subsidiaries and daughter companies in the region due to the relatively high returns available in emerging markets with underdeveloped financial systems. In several SEE countries foreign banks had acquired substantial holdings in the domestic banking sectors and were easily able to expand their operations due to the growing demand for credit. The high penetration of foreign banks in the region is noteworthy, with the exception of Moldova, Slovenia and Turkey. Elsewhere the asset share of foreign banks had, by 2008, reached over 75%, and in Albania, Bosnia and Herzegovina, Croatia and Macedonia it had reached over 90%.

The share of domestic credit to the private sector as a percentage of GDP also increased over the five years from 2003-2008. The highest share of domestic credit to the private sector, often taken as an

indicator of financial liberalisation, was reached in Croatia (68.1%), Bulgaria (71.1%) and Slovenia (85.1%) in 2008. In addition, domestic lending was often denominated in foreign currency, a factor which has led to increased instability especially in 2011 when the rise in value of the Swiss franc led to serious distress among mortgage borrowers in Croatia and elsewhere⁵.

FIGURE 2: Domestic Credit Growth 2008 and 2009 (% p.a.)



Source: EBRD online data 2011

From 2003-2008, Albania, Bulgaria, Romania and Serbia experienced annual rates of credit growth in excess of 30%. In Bosnia and

⁵ In August 2011, the Croatian government and banks agreed to fix the exchange rate for housing loans denominated in Swiss francs at 5.80 kuna per franc for a period of five years in order to ease pressure on borrowers (Reuters 17 August 2011). The difference between the actual payments under the fixed rate, and the contracted payments under the actual exchange rate, will be repayable at the end of the period, plus an interest payment on the outstanding amount charged at a rate of 3.95 per cent per annum. The problem was widespread. In June 2011, some 300,000 households in Hungary defaulted on their mortgage loans.

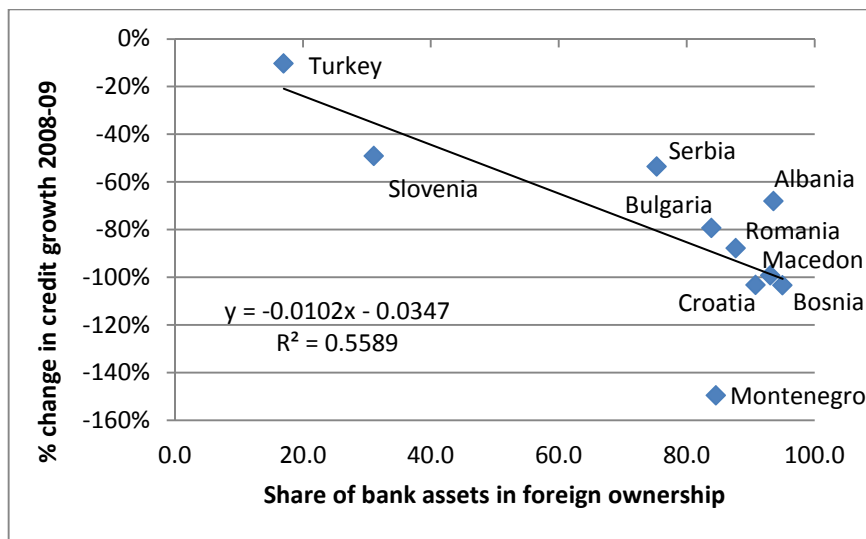
Herzegovina, Macedonia, Slovenia and Turkey, average annual rates of credit growth were between 20% and 30% over this period. Croatia, which had the highest share of domestic credit to GDP in 2003 managed to keep credit growth within reasonable bounds, averaging 15% over the period, due to restrictions by the central bank. By 2008, annual rates of credit growth exceeded 30% in six countries (see Figure 2).

One of the hallmark features of the economic crisis was a sudden collapse of credit on a global level as banks stopped lending to each other in fear of unknown and uncertain exposure to toxic debts (Roubini 2010). This effect was also experienced in South East Europe where a sudden stop in credit growth struck almost all the countries at the same time. Turkey was relatively little affected, as most of its banks were domestically owned, although credit growth even fell sharply in Slovenia which also had a low penetration by foreign banks. Credit growth came to sudden stop in 2009 in Bosnia and Herzegovina, Croatia, and Macedonia, and fell sharply in Albania, Bulgaria, Slovenia and Romania. In Serbia, credit growth remained above 10%, but being far lower than what had gone before had a dramatic negative effect on the economy (Petrović, 2011). The sudden stop in credit growth meant that banks were no longer lending to the business sector and businesses were unable to roll over their loans. This, together with the generally deteriorating economic conditions led to a dramatic increase in non-performing loans in the region. Between 2008 and 2009 the proportion of non-performing loans increased everywhere in the region. It exceeded 10% in Albania, Macedonia and Montenegro, countries which had experienced the most rapid rates of credit growth in the pre-crisis

period⁶. Defaults have continued to increase, reaching almost 18% in Serbia by the end of 2010 (Cetković, 2011).

In 2009, after the credit crunch struck, the fall in the rate of domestic credit growth⁷ seems to have been greater in those countries which had a higher presence of foreign banks (see Figure 3). While there may be other reasons for the variation in the relationship between these two variables, the observed correlation between them is indicative that in SEE the transmission of the crisis through the credit channel may have been affected by the initial structural conditions of the banking sector (the share of foreign ownership).

FIGURE 3: Change in Domestic Credit Growth (2008-09) and Foreign Bank Ownership (2008)



⁶ EBRD online data 2011

⁷ The change in the rate of domestic credit growth is computed as the proportional difference in the rate of domestic credit growth in 2008 and 2009 respectively.

The significance of this relationship may become even more profound as the next stage of the crisis unfolds related to the increasing risk attached to eurozone sovereign debt. This latest manifestation of the crisis may pose further dangers to the SEE countries in the near future. Greece has been particularly affected by the fall in credit rating of its sovereign debt, which is having spillover effects on the solvency of Greek banks. Reportedly, Greek banks stopped making transfers to SEE subsidiaries in 2009, leaving them to fund their lending entirely out of local deposits⁸. Given the depth of the crisis in Greece there is a chance that Greek banks may significantly reduce their exposure in the SEE region as a result of funding and liquidity pressures on the Greek parent banks (Kekic, 2010). Also, sovereign debt risks may spread to some SEE countries should external debt to GDP ratios rise to unsustainable levels, and should refinancing this debt become problematic.

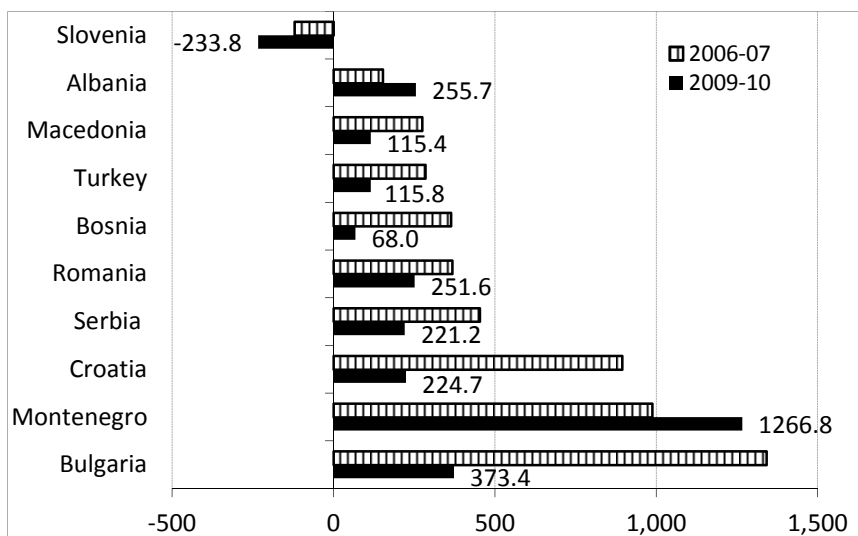
FOREIGN DIRECT INVESTMENT

A major impact of the economic crises has come through sharp reductions in the inflows of foreign direct investment (FDI). Large FDI inflows came to Croatia, Bulgaria, Romania and Turkey, although other countries of the Western Balkans were less successful in attracting large scale FDI. Slovenia was the only country exporting FDI. In per capita terms, the largest pre-crisis net FDI inflows were achieved by Bulgaria, Croatia and Montenegro in 2006-2007 (see Figure 4). In all countries, except Albania and Montenegro, the inflow of FDI fell sharply as a consequence of the economic crisis. Comparing per capita inflows for 2009-2010 with those which had been achieved in 2006-2007, it is noticeable that the sharpest falls took place in Bulgaria and Croatia, the

⁸ Patrick Jenkins and Kerin Hope (2009) "Greece sees few glimmers of hope", Financial Times, 15/12/09.

countries with the highest pre-crisis per capita inflows⁹. This suggests that the extent of openness to flows of foreign direct investment has been a major cause of the transmission of the crisis to the region in this group of countries.

FIGURE 4: Net FDI Inflow Per Capita 2006-2007 & 2009-2010 (US\$)



Source: EBRD online data

In SEE, FDI has been concentrated in a narrow range of sectors and distributed unevenly through time. In the Western Balkans the largest FDI inflows have been strongly linked to privatisation in sectors such as telecommunications, banking and oil refining. The widespread foreign investment in the banking sector has integrated the region into global finance and capital markets, reducing interest rates, increasing the availability of loans, and providing a strong stimulus to economic

⁹ In Montenegro per capita inflows did not begin to decrease until 2010.

growth. The EBRD has argued, on the basis of cross-country growth regressions, that financial integration contributed to economic growth in the region over the last decade but that on the downside it also encouraged credit booms and over-borrowing, especially in foreign currency, which has increased vulnerability of the region (EBRD 2009: chapter 3). A significant recent factor in the development of FDI in the region has been the increasing activity of intra-regional investment. As mentioned above Slovenian companies have begun to make large investments in the Western Balkans, and in recent years there have been some major investments by Croatian companies too.

REMITTANCES

Remittance flows are a key transmission mechanism for the impact of the economic crisis on the SEE countries. Moldova, Bosnia and Herzegovina, Albania, and Serbia¹⁰ stand out with very high shares of remittance income in GDP. Remittances have so far held up in Albania and Serbia, while they have fallen sharply in Moldova and Romania (see Table 2). This may have been an important contributing factor in the sharp fall in GDP in these two countries in 2009. There is however no clear reason why these countries have been especially affected in this way.

Data on remittances are by their nature difficult to obtain and their reliability is questionable. For example, the data on remittances to Macedonia are highly disputed. Bucevska and Bucevska (2009) estimate remittance flows to Macedonia at an average annual level of 14% of GDP over the period from 2000-2008.

¹⁰ Kosovo also relies highly on remittances to finance its economy, but the data is sparse and unreliable.

TABLE 2: Remittances

	Remittances as a share of GDP, 2008 (%)	% decline in remittance flow 2008-09
Moldova	31.4%	21.4%
Romania	4.7%	14.7%
Bulgaria	5.3%	5.0%
Bosnia and Herzegovina	14.8%	3.9%
Slovenia	0.6%	2.5%
Greece	0.8%	2.5%
Croatia	2.3%	1.9%
Turkey	0.2%	1.8%
Serbia	11.1%	1.8%
Macedonia	4.3%	1.3%
Albania	12.2%	0.0%

Source: World Bank remittances data base

EXPORTS

One of the main transmission mechanisms of the crisis has been external demand for exports from the EU, the main trading partner for the region. Jovičić (2009) studied the relationship between the degree of trade integration to the EU market and the timing and intensity of the onset of the crisis effects among the Western Balkan countries. She found that while those with a high degree of trade integration experienced the crisis sooner, those with a lower degree of integration experienced a larger decrease in production.

Table 3 shows the extent of the collapse in merchandise exports in the region between 2008 and 2009. Exports in all countries fell by more than 20% over the year, with the largest drop in Montenegro and Macedonia where merchandise exports fell by one third or more

TABLE 3: Merchandise Exports (US\$ millions)

	2008	2009	% Change
Montenegro	684	411	-39.9%
Macedonia	3,971	2,685	-32.4%
Bulgaria	22,484	16,503	-26.6%
Croatia	14,460	10,718	-25.9%
Serbia	10,957	8,366	-24.0%
Slovenia	29,607	22,502	-24.0%
Romania	33,725	29,117	-22.7%
Albania	1,356	1,048	-22.7%
Turkey	140,801	109,672	-22.1%
Bosnia	5,194	4,080	-21.4%

Source: EBRD Online data 2011

4. Institutions

The role of institutions in explaining economic growth differences among transition countries has recently attracted much attention. A general link between institutional quality and economic growth in transition countries has been demonstrated by Beck and Laeven (2006). Theories of the political economy of transition have stressed the negative impact of uncompleted transition on economic growth (Hellman, 1998). Ruling elites may engage in rent seeking behaviour so as to benefit from dominant positions connected to large state or private companies with a significant market share, blocking the entry of new entrepreneurial firms.

Overall, the institutional features which may determine the impact of the economic crisis relate to progress with transition to a market economy, the quality of institutions which have been developed, and the quality of government policy making. In addition, countries which have made most progress in integrating with the EU and in adopting EU-compatible institutions may be more vulnerable to the crisis, as they may be more open to the transmission effects through financial flows and falling export demand. At the same time they may also be better placed to benefit from the recovery, since businesses in those countries operate within a more supportive institutional environment.

A different approach, which identifies different 'varieties of capitalism', places more emphasis on 'institutional complementarities' than to the identification of interest groups which block reform. These institutional complementarities define a limited cluster of forms of capitalism. Amable (2003) distinguishes between the Liberal Market economy, the Continental European model, and the Mediterranean model of capitalism. Key institutions which distinguish capitalist systems include the configurations of product markets, labour markets, systems of

finance and corporate governance, the welfare system and the education system. Different combinations of these give rise to different models of capitalism within which *institutional complementarity* enables distinct models to evolve over time. These different forms of the capitalism might be expected to display different responses to the impact of global economic crisis.

A related approach to the analysis of the varieties of capitalism suggests that economies differ in the degree of coordination among the social partners, with some having more coordination (Continental European corporatism) while others have more atomised market structures (Liberal Market model) (Lane and Myint, 2006). The latter should be more susceptible to market fluctuations. Within South East Europe, the Western Balkan countries have relied heavily on international assistance and the institutional mix which has emerged has typically been based on policy transfer from a variety of different sources and on uncoordinated policy advice. This has resulted in a rather exotic mixture of economic and social reforms, and the institutional configurations that have emerged have often been neither complementary nor compatible (Bartlett 2006). The emergent forms of capitalism therefore may not fall neatly into the boxes identified in the varieties of capitalism literature.

EU INTEGRATION

The accession process has required countries to gradually adopt EU-compatible reforms in order to harmonise their laws to the *acquis communautaire*, create new institutions such as Competition Agencies, and reform existing institutions to conform to EU standards. In deciding whether to proceed through any stage of the accession process, ruling elites must weigh up the costs of implementing reforms against the

benefits of accession. If the costs of accession are greater than the benefits for the decision making elite, then a country may turn away from the EU integration process. However, since the benefit of EU accession is rather high for most of the Western Balkan countries, a strategy of non-accession would most likely only be chosen by ruling elites which have much to lose from adopting EU rules.

Table 4: Progress with EU Integration and Average GDP Growth 2009-2010

EU membership and accession status	Country	Average growth GDP 2009-10
EU Members	Bulgaria, Greece, Romania, Slovenia	-3.4
Candidate states	Croatia, Macedonia, Montenegro, Turkey	-1.3
Potential candidates	Albania, Bosnia and Herzegovina, Serbia	0.5

Source: Table 1

Belke et al. (2009) have shown that progress with EU integration has a positive effect on institutional quality as measured by the World Bank Governance Indicators. During periods of instability however, these elements of market integration and institutional formation may facilitate the transmission of market disturbances to the more integrated countries. While some have engaged with this process more enthusiastically than others, it seems that there is a clear relationship between the degree of EU integration in the SEE region and the extent to which countries were adversely affected by the economic crisis (Table 4).

TRANSITION PROGRESS

Studies of the relationship between transition progress and economic growth have focused on the distinction between initial conditions and

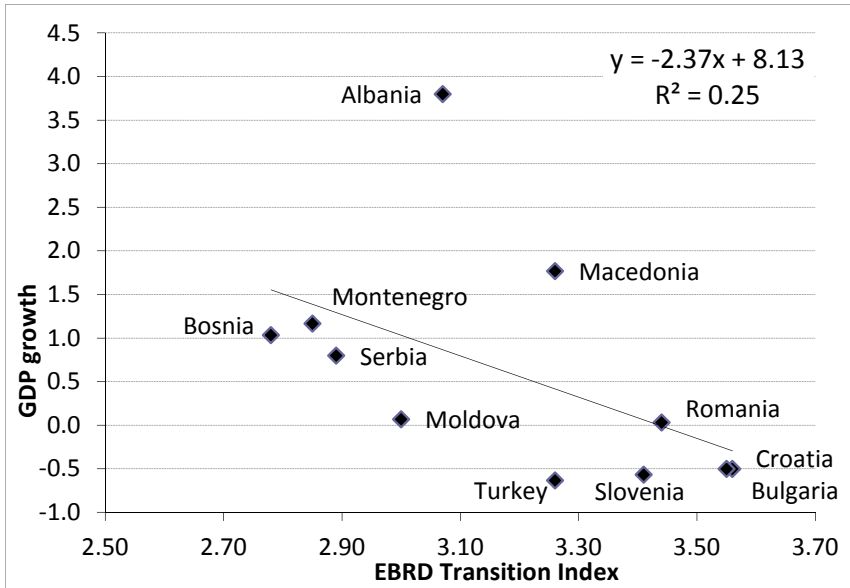
subsequent policies. De Melo et al. (2001) found that, following a negative initial impact, liberalizing reforms have a positive long-run effect on growth and that the effect of reforms is stronger, the more adverse are the initial conditions. Over time, the impact of initial conditions inevitably diminishes and the positive impact of reforms comes to the fore (Falcetti et al. 2005). Thus, in Serbia and Montenegro, the anti-reform coalition which initially resisted reforms eventually lost influence as the extent of the losses which the majority had suffered from blocked reforms became apparent. Subsequently, the pro-reform coalition which came to power after 2000 was able to make rapid progress with reform from that time on. Applying the calculus of winners and losers to the Western Balkans, the early reformers who braved the cost of reform enjoyed a growth premium (Bartlett 2008). In contrast, the late reform countries, where anti-reform coalitions were able to mobilize blocking majorities from among the potential losers suffered, and are still suffering, a growth penalty.

The extent to which countries have made progress with transition and have become functioning market economies has been identified by an index computed by the European Bank for Reconstruction and Development (EBRD) which presents expert evidence on the extent of transition along various dimensions. Panel data regression studies have shown that real GDP per capita growth rates in transition economies are positively associated with the extent of progress with transition as measured by the EBRD index, other indices of transition reforms, as well as macroeconomic stabilisation policies and changes in the terms of trade (Falcetti et al. 2005; Iradian 2009)¹¹. In SEE, in the early stages of transition between 1991 and 2004, the correlation between reform progress and economic growth was positive in Albania, Croatia and

¹¹ Some earlier studies failed to identify this effect. See e.g. Fidrmuc (2003).

Macedonia, while it was all but zero in Serbia where reforms made least headway in the 1990s (Bartlett 2008).

Figure 5: GDP Growth and progress in transition



Source: EBRD online data; Note: GDP growth is average for 2008-2010

The simple analysis performed in Figure 5 suggests that there may be an overall negative relationship between progress with transition and the average growth during the crisis period. This indicative finding is opposite to what might be expected if transition were to lead to a more flexible market economy. The rationale behind that would be that a greater progress with transition leads to increased integration into the global economy. As already mentioned above, this relation emphasises the strength of the transmission of effects from the external environment to domestic economies may depend on initial institutional conditions at the start of the economic crisis.

De Macedo et al. (2008) propose a useful extension to this literature which incorporates Amable's (2003) idea of institutional complementarity into the analysis of the effect of transition progress on growth. They create an innovative 'reform complementarity' index based on the EBRD data, and demonstrate a U-shaped relationship between complementarity and level of reforms. This suggests that performance may deteriorate as lop-sided reforms are initially introduced, before improving as reform complementarities come into line as the scope of reforms widens over time. In future research it would be interesting to investigate the effects of such complementarities on the ability of countries to mitigate the effects of the economic crisis.

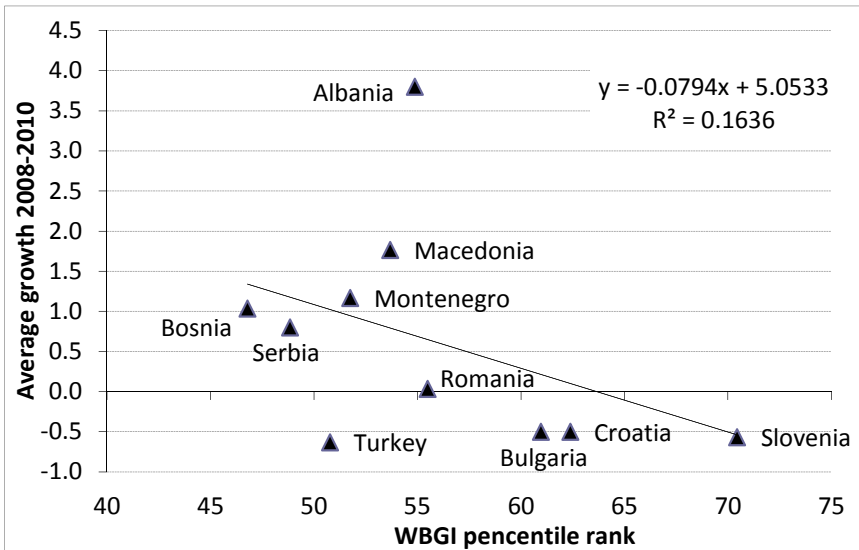
THE QUALITY OF GOVERNANCE

The broad institutional environment measured through the World Bank Governance Indicators (WBI) provides an alternative measure of institutional quality which may affect the ability of countries to respond flexibly to the economic crisis. In a recent study, Beck and Laeven (2006) use this measure of institutions to show that institutions positively affect growth in transition economies. The WBI measures various aspects of institutional quality including the rule of law, government effectiveness, and measures to deal with corruption. If institutional quality positively influence growth, then we may expect that it would also serve to moderate the impact of the crisis, or at least lead to a rapid recovery.

Figure 6 shows the simple bi-variate relationship between the 3-year average growth rate 2008-2010 and institutional quality measured by the WBI scores. The correlation coefficient between the two variables is -0.4. Slovenia, with the highest quality of institutions, has the lowest

growth rate next to Turkey, while Albania with the highest growth rate has only an average level of institutional quality. Improved institutional quality appears to offer little advantage to countries in resisting the effects of the crisis on their economies. There is also an inverse relationship between institutional quality and volatility over the period (correlation coefficient = -0.37). Countries with higher quality of institutions appear to have greater volatility in reaction to the effects of the economic crisis. That is, they have sharper downturns and recoveries, taken together. Again, the explanation may be that improved institutional quality goes along with greater integration into the global economy, making countries more susceptible to the effects of the crisis transmitted from abroad.

Figure 6: Institutional quality and real gdp growth in see 2008-2010



Source: World Bank Governance Matters database and EBRD online data

5. Policy Responses

The above review has identified the main external transmitters of the crisis: collapse of credit growth, FDI inflows, remittances and exports. While export demand fell sharply in 2008-09 it has now largely recovered, but the large inflows of foreign capital which financed the current account deficits are unlikely to return. This suggests that the appropriate policy response will have to focus on boosting the domestic drivers of growth such as improved competitiveness and business environment, increased domestic savings and a better skilled labour force (European Commission 2010a). Handjiski et al. (2010) point to the need to boost regional trade integration within CEFTA. Sanfey points more generally to the need for cross-border cooperation in trade and others areas (Sanfey 2010). Others point to the need more generally to boost export growth through raising domestic competitiveness and directing capital imports towards the tradable goods sectors (EBRD 2010). A review of the various explanations of the crisis and the main policy recommendations that have been proposed is set out in Snoy (2011).

Most of the above are medium to long term policy prescriptions. In the face of the economic crisis, policy makers have focused more on the short-term reactions to address immediate problems. These short-term policy responses to the economic crisis can be considered from the side of (i) domestic policy response and (ii) the response of the international financial organisations and the international development banks.

DOMESTIC POLICY RESPONSES

National governments have responded to the economic crisis with a set of actions which have combined elements of stimulus and austerity,

with an emphasis on the latter. On the side of monetary policy, these have involved deposit guarantees, liquidity injections, and recapitalisation of banks. Croatia, for example, adopted an aggressive programme of monetary easing by reducing the reserve requirements and other emergency measures (Gardo 2010). To stabilise banks and prevent bank runs, many governments in the region raised the level of deposit insurance and introduced government deposit guarantee schemes up to certain limits (Sanfey 2010).

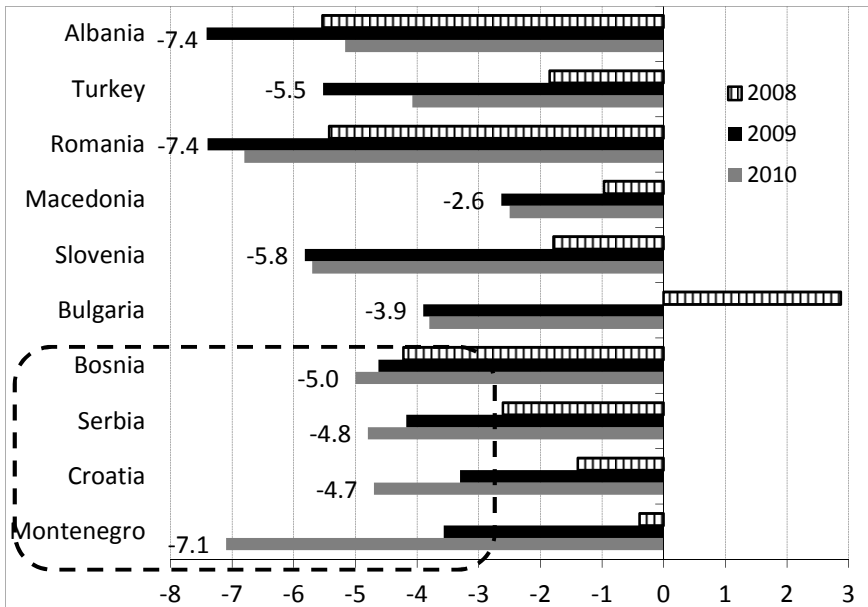
On the side of fiscal policy, the countries of SEE are far more constrained than the developed countries of the West as they are less able to raise finance on the international markets to cover external deficits. In 2008 most countries, with the exception of Albania, Bosnia and Herzegovina and Romania, had some fiscal space to absorb the initial effects of the crisis with fiscal deficits below 3% of GDP. This initially favourable fiscal position followed from efforts over the previous decade to control public expenditure in line with IMF advice and EU pre-accession programmes. In 2009, however, government budget balances deteriorated in all countries as tax revenues fell and small fiscal stimulus packages were introduced¹². In 2009, budget deficits rose above 3% of GDP everywhere (except Macedonia) while in Albania and Romania the budget deficit reached 7.4% (see Figure 7).

In 2010, the deficits fell in Albania, Bulgaria, Macedonia, Romania, Slovenia and Turkey partly due to the austerity measures but also to a recovery in tax revenues following modest economic growth. In a few countries budget deficits continued to widen: in Bosnia and Herzegovina and Serbia which had permissive IMF programmes in place,

¹² An account of the fiscal stimulus measures can be found in Sanfey (2010) who concludes that “All of these measures have brought some relief here and there, but they cannot be said to constitute a coherent anti-crisis approach” (Sanfey 2010: 11.)

and in Croatia and Montenegro where negative growth in 2010 further depressed tax revenues.

Figure 7: Government budget balance 2008, 2009, 2010 (% GDP)



Source: EBRD online data 2011

As budget balances deteriorated, most SEE countries introduced austerity programmes to reign in their budget deficits. Croatia introduced a public sector salary freeze and a wide range of spending cuts in 2009, and in 2010 adopted an Economic Recovery Programme which involved *inter alia* limitations on the duration of unemployment benefits. Serbia introduced a series of anti-crisis measures in 2008 which were “partially restrictive and partially stimulating” (GoS 2008). Stimulating measures included support for SMEs and for export oriented companies. Measures were also introduced to stimulate foreign investment and to provide additional guarantees for the

financial sector. Restrictive measures included a budget deficit target of 1.5% of GDP, cuts to salaries of civil servants, restrictions on pensions and social benefits. The public sector workforce was also to be cut by 10%. In neither case were the measures effective in preventing a sharp deterioration in the government budget balance over the period 2008-2010.

Among members of the eurozone, Slovenia adopted an adventurous fiscal stimulus package amounting to 2.1% of GDP in 2008 order to counteract the impact of declining external demand leading to a tripling of its fiscal deficit in 2009. Fiscal stimulus thus soon became unsustainable. It was immediately followed in 2010 by tough austerity measures designed to reduce the government deficit below 3% of GDP and at stabilising general government gross debt at 45% by 2013, involving budget cuts amounting to 2.8% of GDP in 2010 and similar cuts programmed for the next two years (OECD 2011). Greece - another eurozone member - has entered into a fully-fledged public debt crisis with a budget deficit of 15.4% of GDP in 2009, and had to introduce dramatic budget expenditure cuts amounting to 6% of GDP in 2010, to be followed by further substantial expenditure cuts to reduce the deficit below 3% by 2014 in order to reassure the international financial markets about its creditworthiness.

Commenting on the economic and fiscal programmes of the potential candidate countries in 2010 the European Commission concluded that: "The medium-term fiscal framework appears to be cautious in the case of Montenegro, broadly plausible for Serbia, slightly optimistic in the case of Bosnia and Herzegovina and optimistic for Albania. All programmes fail to spell out in sufficient detail the medium-term measures underlying the planned improvement in the fiscal balance" (European Commission 2010).

Differences in the exchange rate policies did not seem to have much effect on export performance during the early period of the economic crisis; as discussed above exports fell almost uniformly by between 20% and 30% (see Table 3). The countries in the region have adopted different exchange rate regimes: currency boards in Bulgaria, Bosnia and Herzegovina, unilateral euro adoption in Kosovo and Montenegro, managed floats in Croatia and Serbia, a hard peg in Macedonia and a floating exchange rate in Albania¹³. Countries which have adopted fixed exchange rates and hard pegs, as well as those which have borrowed heavily in foreign currency, such as Croatia, have taken active monetary policy measures to constrain credit growth, and in some cases sharply raise interest rates to defend their currencies and stem losses of scarce foreign exchange reserves. Macedonia for example raised its central bank interest rate from 7% to 9% when the crisis began, at the end of 2008. However, it could be argued that in countries with permanently fixed exchange rates the recovery could be slower than elsewhere, as it could take more time to adjust domestic wages and prices to restore international competitiveness to recover lost export markets¹⁴.

INTERNATIONAL POLICY RESPONSE

It is possible that the impact of the crisis on the SEE region would have been much greater if it had not been for a concerted and effective policy response from international institutions (Cviić and Sanfey, 2010). This response ranged from IMF support programmes to tailored agreements between international institutions and commercial banks to ensure continued lending to the region. Starting in 2009, IMF support

¹³ Available evidence seems to show that transition countries which adopted fixed exchange rates had lower inflation and higher rates of growth than countries which did not, controlling for other relevant factors (De Grauwe and Schnabl, 2008)

¹⁴ This argument is also presented in the EBRD Transition Report (2009: 17).

programmes have been directed towards Romania (through a €3.5bn Stand-by Agreement), Bosnia and Herzegovina (€1.1bn), and Serbia (€402.5m). These measures were designed in part to stem capital flight by supporting fiscal consolidation and encouraging parent banks abroad to remain committed to the countries involved.

The support from the IMF was backed up by the “Vienna Initiative”, a multilateral agreement which ensured that host governments would provide deposit insurance and liquidity support for the banks, that EU-based parent banks would recapitalise and refinance their subsidiaries in the region, that home governments would allow bank groups to access home country financial resources without restrictions, and that the MDBs would provide large-scale financial support. This agreement was designed to prevent foreign-owned banks from pulling out of the region by committing them to refinance loans that they had placed domestically. It was one of the most important factors in stabilising the banking system in SEE early in the crisis. However, new risks are emerging as a consequence of the continuing eurozone sovereign debt crisis, and it is quite likely that further international interventions will be required.

6. Conclusion

As elsewhere in Central and Eastern Europe, transition countries in the European super-periphery have been adversely affected by external events originating in the USA and the core EU member states. While the global economic crisis has had a severe negative impact on the SEE region, its magnitude has varied across countries. Some countries were very badly affected in 2009 with sharp declines in GDP, industrial production and exports, while other countries have been relatively less affected. In some countries the contraction persisted in 2010, while in others only a shallow recovery was evident. Only Albania and Turkey were exceptions to this general picture. The paper has addressed the reasons for these differences in economic performance.

From late 2008, the global economic crisis led to the collapse of external sources of finance for SEE, which had been the main driver of rapid growth in the region since 2000. Four main channels transmitted the effects of the crisis to the SEE region: a sharp contraction of foreign credits to local banks, a sharp reduction in FDI inflows, a precipitate fall in demand for exports, and falling remittance income. The findings relating to these four factors are that (i) the fall in the rate of domestic credit growth was greater where there was a higher presence of foreign banks, (ii) the falls in FDI were greater where pre-crisis per capita inflows were higher (iii) a uniformly large reduction in exports took place across the board, (iv) remittances fell only in Romania and Moldova, perhaps due to special factors but more likely the data are unreliable. Thus, overall it seems that initial structural conditions do explain some of the variation in crisis impact such that the more integrated economies seem to have been more badly affected.

The paper has also investigated whether the different institutional structures which were created during the transition period have had

any discernible effect on the different ways in which the crisis impacted on the countries of the region. The analysis suggests that those countries which have made most progress in creating a modern institutional framework supportive of private enterprise and a competitive market economy, and which have consequently become the most integrated into global and European markets have suffered the worst impact of the crisis. For example, countries which have made more progress in transition, including Bulgaria, Croatia, Slovenia, and Romania, which have a higher degree of EU integration, and have higher 'quality of institutions', are those which have experienced the highest rate of negative growth of GDP over the two year period from 2009-10. This indicates that their progress in adopting market-friendly institutions, which provided a base for the development of a capitalist economy, has simultaneously increased their vulnerability to external shocks. Countries which have made less institutional progress were less affected by the external shock of the global economic crisis.

Policy responses to the crisis also differed, at least initially. At first, measures were applied to boost growth through small scale fiscal stimulus measures such as tax breaks for businesses, and through easing monetary policies. Lacking the fiscal space to sustain such stimuli, however, governments were soon forced to revert to austerity measures to restrain public expenditure, which had previously been the main domestic source of economic growth. All of this has resulted in the region becoming even more dependent on the support of international financial institutions. The Vienna Initiative supported the position of foreign banks in the region early on in the crisis. However, there are signs that some banks are beginning to feel the effects of bad loans and are now experiencing major difficulties. With the eurozone crisis continuing, the increasing number of foreign banks from European countries that are undergoing difficulties poses yet another risk of default for these countries, especially in cases where the ratio of

external debt to GDP is approaching 100% or more (Bulgaria, Croatia, Montenegro and Slovenia).

Our overall conclusion therefore is that (i) there is some evidence that the countries that were more integrated into the EU were more affected by the crisis, especially through the credit and foreign investment channels, that (ii) countries which made more progress with transition were more affected, possibly because this has led to deeper structural and institutional integration to the EU, and (iii) policies have everywhere tended towards austerity, but with differing degrees of success in reducing budget deficits. While international support has been important, this merely highlights the structural fragility of the countries of the region which have received such support.

As the crisis is expected to deepen in the future in the absence of a sustainable solution to the ongoing crisis of sovereign debt in the eurozone periphery (e.g. Greece, Portugal, Spain, Italy) it is quite likely that the effects will spill over even more deeply than before in the SEE region. As we can see from the drama that is unfolding in the EU, the crisis is far from over. This will not be a sprint but a marathon, it seems. So, the question remains whether those countries that are less integrated into the EU and hence have been less deeply affected by the crisis will recover more quickly from it. In Serbia, for example, the ongoing risks are higher than might be thought from inspection of data on GDP growth alone, especially as these do not correspond with the data showing declining industrial production and increasing unemployment; in fact, a drop of between 4% and 5% of GDP in 2009 is more in line with all the other available data than the recorded drop of just 1%. That would put Serbia at a much higher risk of a long recession, as could also be expected in several other countries in the region. Bearing in mind our previous analysis, and the fact that all the countries in the region substantially depend on the EU for markets and for

finance, it seems logical that the more progressive economies that are more closely related to the EU will stand to gain from the recovery to a greater extent, while the countries that have failed to make a successful transition to a pro-market variety of capitalism, and have instead adopted a Mediterranean (or Balkan) style of capitalism relying on a high degree of state intervention and low institutional complementarity, may prove less adaptable in responding to the opportunities presented by the future economic recovery when and if it eventually takes place.

References

- Amable, B. (2003) *The Diversity of Modern Capitalism*, Oxford: Oxford University Press.
- Bartlett, W. (2010) "The social impact of the global economic crisis in the Western Balkans" *PECOB Papers Series No. 1*, University of Bologna.
- Bartlett, W. (2008) *Europe's Troubled Region: Economic Development, Institutional Reform and European Integration*, London: Routledge.
- Bartlett, W. (2006) "The Western Balkans" in: D. Lane and M. Myant (eds.) (2006) *Varieties of Capitalism in Post-Communist Countries*, Basingstoke: Palgrave
- Beck, T. and Laeven, L. (2006) "Institution building and growth in transition economies", *Journal of Economic Growth*, 11: 157-86
- Belke, A., Bordon, I., Melnykovska, I. and Schweickert, R. (2009) "Prospective membership and institutional change in transition countries", *Kiel Working Paper 1562*, Kiel Institute for World Economy
- Bucevska, V. and Bucevska, J. (2009) "Econometric estimation of the impact of economic crisis on remittances flows from Germany to Macedonia", paper presented to the conference on *Economic Policy and Global Recession*, organised in association with the European Association for Comparative Economic Studies, Belgrade, 25-27 September
- CPESSEC (2011) *Statistical Bulletin No 3*, Zagreb: Centre for Public Employment Services of South East European Countries
- Cvetković, P. (2011) "Credit growth and instability in Balkan countries: the role of foreign banks", *Research on Money and Finance Discussion Papers No. 27*, London: SOAS, University of London
- Cviić, C. and Sanfey, P. (2010) *In Search of Balkan Recovery: The Political and Economic Re-emergence of South-Eastern Europe*, London, Hurst & Company.
- De Grauwe, P. and G. Schnabl (2008) "Exchange rate stability, inflation, and growth in (South) Eastern and Central Europe," *Review of Development Economics*, 12(3): 530-549
- De Macedo, J. B. and Martins J. O. (2008) "Growth, reform indicators and policy complementarities", *Economics of Transition*, 16(2): 141-164.

- EBRD (2008) *Transition Report 2008: Growth in Transition*, London: European Bank for Reconstruction and Development
- EBRD (2009) *Transition in Crisis: Transition Report 2009*, London: European Bank for Reconstruction and Development
- EBRD (2010) *Recovery and Reform: Transition Report 2010*, London: European Bank for Reconstruction and Development
- EBRD (2011) *Final Report on the Joint IFI Action Plan*, London: EBRD
- European Commission (2010a) "The pre-accession economies in the global crisis: from exogenous to endogenous growth?", *Occasional Paper 62*, Brussels: DG for Economic and Financial Affairs
- European Commission (2010b) "2010 Economic and Fiscal Programmes of potential candidate countries: EU Commission's assessment", *Occasional Paper 63*, Brussels: DG for Economic and Financial Affairs
- Falchetti, E., Lysenko, T. and Sanfey, P. (2005) "Reforms and growth in transition: re-examining the evidence", *EBRD Working paper No. 90*, London: EBRD
- Fidrmuc, J. (2003) "Economic reform, democracy and growth during post-communist transition", *European Journal of Political Economy*, 19(3): 583-604
- Gardo, S. (2010) "Macrofinancial stability in Croatia in the wake of the global crisis: risks and policy responses", (Austrian Central Bank) *Focus on European integration Issues*, 3:6-37
- GoS (2008) *The Economic crisis and its Impact on the Serbian Economy: Framework of Measures*, Belgrade: Office of the Prime Minister
- Handjiski, B., Lucas, R., Martyin, P. and Guerin, S.S. (2010) "Enhancing regional trade integration in Southeast Europe", *Working Paper No. 185*, Washington: World Bank.
- Hellman, J. S. (1998) "Winners take all - The politics of partial reform in post-communist transitions", *World Politics* 50(2): 203-
- Jovičić, M. (2009) "The onset of the economic crisis in the West Balkans", paper presented to the conference on *Economic Policy and Global Recession*, Belgrade, 25-27 September

- Kekic, L. (2010) "The Greek crisis – the threat to neighbouring Balkan economies", in: W. Bartlett and V. Monastiriotis (eds.) *South Eastern Europe in Crisis: a new dawn or back to business as usual?*, London: LSEE, London School of Economics and Political Science, pp. 45-50.
- Lane, D. and Myant, M. (eds.) (2006) *Varieties of Capitalism in Post-Communist Countries*, Basingstoke: Palgrave
- Milesi-Ferretti, G. and Tille, C. (2011) "The great retrenchment: international capital flows during the global financial crisis", *Economic Policy*, (April): 287-342.
- Mitra, P., Selowsky, M. and Zalduendo, J. (2010) *Turmoil at Twenty: Recession, recovery and reform in Central and Eastern Europe and the former Soviet Union*, Washington: World Bank
- OECD (2011) *Restoring the Public Finances*, Paris: OECD.
- Petrović, P. (2011) "Economic crisis in Serbia: impacts and responses" in: W. Bartlett and V. Monastiriotis (eds.) *South Eastern Europe in Crisis: a new dawn or back to business as usual?*, London: LSEE, London School of Economics and Political Science, pp. 113-119.
- Prica, I. and Uvalić, M. (2009) "The impact of the global economic crisis on Central and South Eastern Europe", paper presented to the conference on *Economic Policy and Global Recession*, Belgrade, 25-27 September
- Roubini, N. and Nihm, S. (2010) *Crisis Economics*, London: Allen Lane.
- Sanfey, P. (2010) "South-eastern Europe: lessons from the global economic crisis", *Working Paper No. 113*, London: EBRD
- Snoy, B. (2011) *Synopsis of recent findings and conclusions from studies with respect to the need for new growth initiatives in the Western Balkans and policy options available to the governments of the region*, Brussels: PM Group

