

“NEITHER HOME - NOR DRY”: CONFRONTING THE ECONOMIC AND FINANCIAL SECTOR CRISES IN SOUTHEASTERN EUROPE

Comparative precedents to this economic 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 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.

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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 unpreparedness, 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.

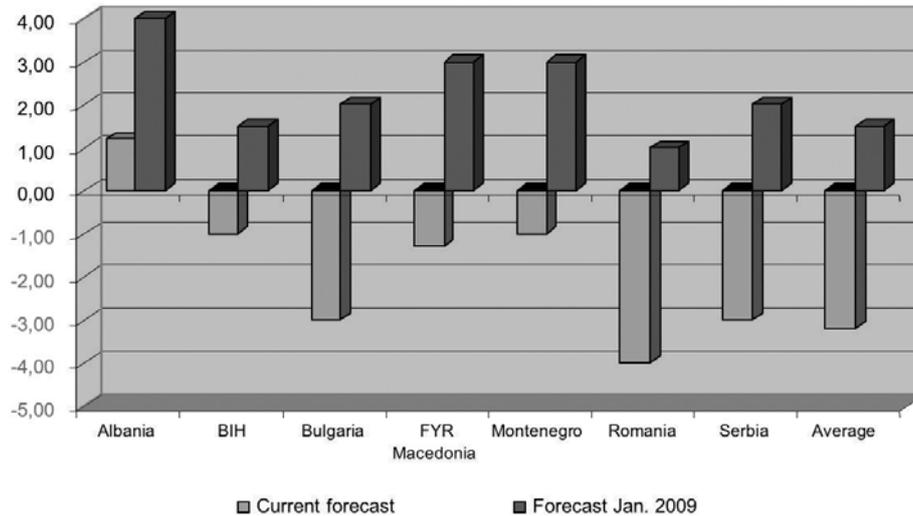
From October 2008 onwards the immediate intervention of multi-lateral financial institutions became the means of last –and only– resort for authorities in Serbia, Bosnia, Hungary, Romania, Ukraine, Belarus etc. At that stage the fast emerging solvency crises in these countries lacked any domestic policy solutions. Instead of going broke, many had to “go cap in hand”; first to Washington (IMF and World Bank), and subsequently to London (EBRD) and Brussels (EU, i.e. EIB). Only through the availability of such external anchors did these countries avoid the modern-day equivalent of financial meltdown and having to throw in the “default towel”.

The Macro-Economic Situation

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 appears to be slightly easing in the second quarter. Southeastern Europe (SEE) is among the regions most adversely affected, reflecting dramatic GDP contraction¹ (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).

¹ GDP performance, measured in terms of economic activity on the upside or downside, is not the most compelling economic indicator. Most basically, G.D.P. represents the sum of domestic economic transactions. It does not however reflect net economic welfare of a given country. See Eric Zencey, *Virgin Forest: Meditations on History, Ecology and Culture*, 2008.

Graph 1: Growth in Real GDP 2009 in Southeast Europe*



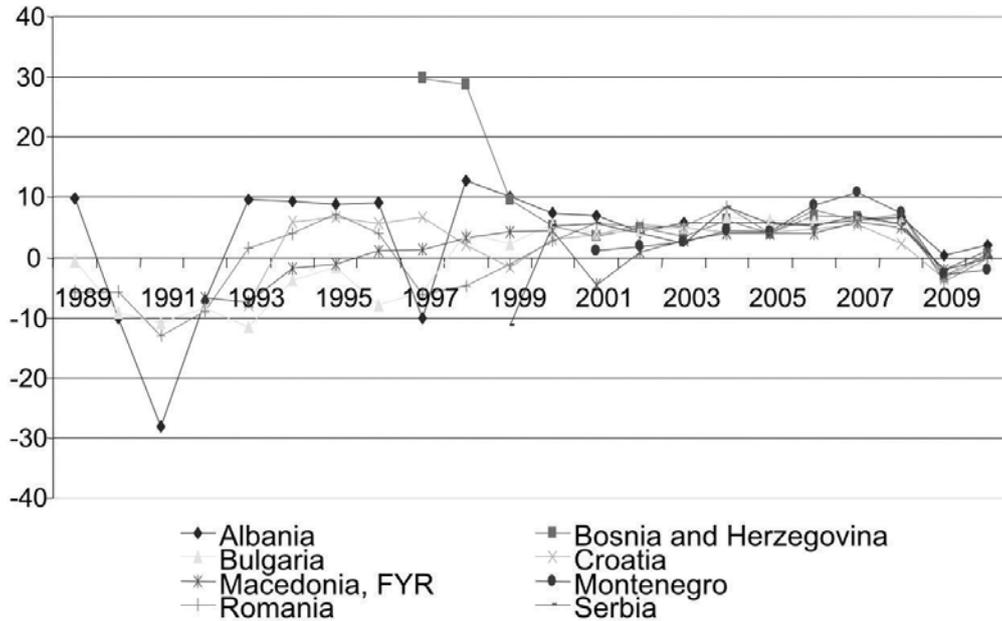
* The EBRD forecasts are as of 7 May 2009. EBRD Press Release, 7 May 2009.

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 only exception to negative GDP performance during 2009 is expected to be Albania (see Graph 1 above).

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 on the next page).

Any economic forecast for the region of Southeastern Europe 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.

Graph 2: Real GDP growth (Annual percent change (1989-2010))



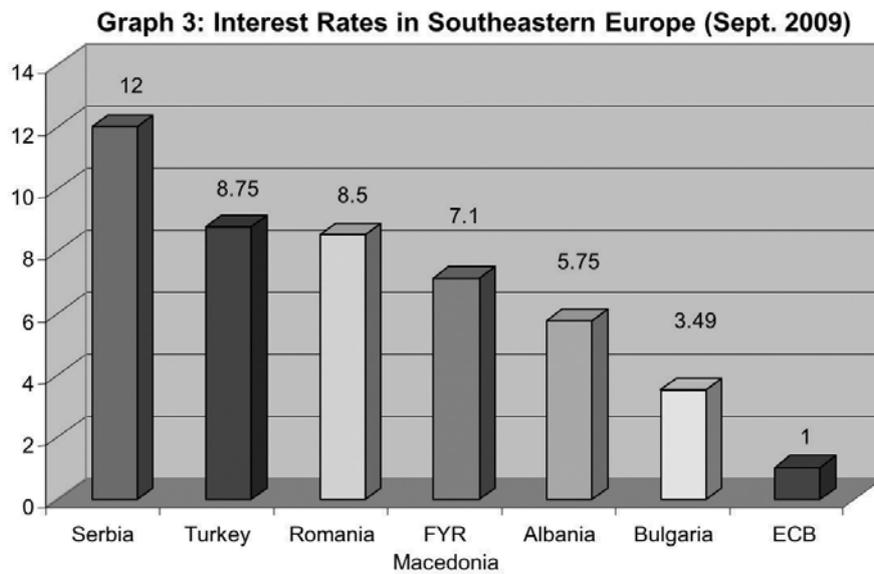
Source: IMF: *World Economic Outlook*, April 2009.

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 *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.

Since many of the economies in Southeastern 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.

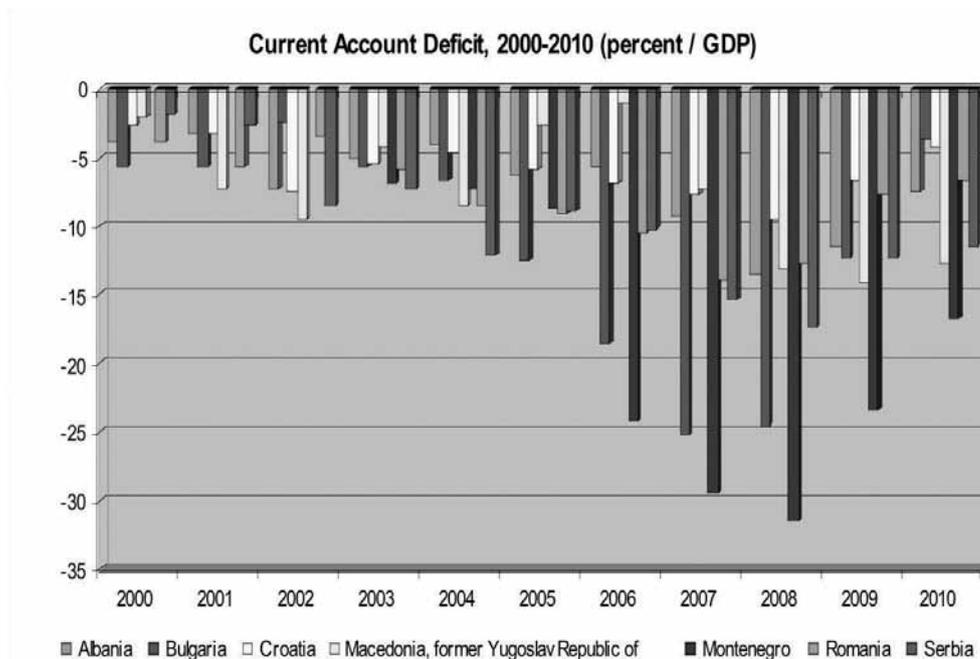
Furthermore, the interest rate differential among southeast European countries and between these and the European Central Bank (ECB) continue to be considerable. As Graph 3 below illustrates, the interest rate spreads are considerable,

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 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.



Source: Central Bank statistics, September 2009 and own research.

With exports stalling, remittances starting to decline (see page 56) and credit growth slowing, the region of Southeastern 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.



Source: IMF: *World Economic Outlook*, April 2009.

Graph 4 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 mid-2008– the adverse effects are immediate and severe, and the necessary adjustments require a painful dose of medicine.

External Anchors to the Rescue

Against this economic background governments in the region have to decide how to modify their policies. 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”.²

² Statement by the IMF Mission to Albania, *Press Release No. 9/119*, 9 April 2009.

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

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

Country	Timing	Volume (USD)	IFIs
Hungary	October 2008	25.4 billion	IMF, WB, EU
Ukraine	November 2008	16.4 billion	IMF
Latvia	December 2008	10.5 billion	IMF + EU
Belarus	January 2009	2.46 billion	IMF
Serbia	January 2009	530 million	IMF
	March 2009	4.0 billion	IMF
Poland	April 2009	20.5 billion	IMF (Flexible Credit Line)
Bosnia & Herzegovina	May 2009	1.3 billion	IMF (Stand-by Loan)
Romania	March 2009	27 billion	IMF, WB, EU, EBRD
Total External Funding		108,4 billion	

Source: <http://www.imf.org/external/np/exr/facts/crislend.htm>

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 (see page 54) and EIB can forward capital financing to individual sectors and companies.

Notwithstanding these differences in approach and substance, the combination and coordination of these interventions sent a significant message to international capital and bond markets during the past eight months; namely that East, Central and Southeast Europe ultimately have a 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 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 27 billion dollars under a two-year stand-by arrangement. The financial package includes a loan of 17.5 billion dollars from the IMF while another 9.7 billion dollars 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 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 while undertaking the first review of Romania’s performance under the 27 billion dollar aid deal, the IMF doubled its forecast for economic contraction in Romania in 2009 to more than eight percent. The change underscores 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.

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, three billion euro 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.

Can Albania and Bulgaria, Croatia and FYR Macedonia be Considered Outliers?

As one country after another sought multilateral funding from a combination of International Finance Institutions (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 will be taken after the establishment of a new coalition government following the general elections from 28 June 2009.

In the case of Bulgaria, political and electoral considerations also had an impact on not approaching the IMF before the outcome of the 5 July 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 25 billion dollars, the volumes secured from the IMF and the EU by Hungary and Romania.³

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 (as a member of the EU) would aim to cover the majority of Sofia's short-term refinancing needs during 2009. How the new government of Prime Minister Borisov 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 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.

³ 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 Borisov's party GERB, which argued in favor of a precautionary agreement with the IMF as part of its economic policy priorities.

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 would rest in interest-rate developments, potential liquidity shortages and minimizing adverse consequences for western commercial banks. This is a complex matter. It would neither be cheap nor pain-free.⁴

Is the Crisis Assistance Discretionary, tilted towards EU Members?

When considering funding assistance from the international [financial] 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 and Herzegovina, Montenegro or Albania.

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

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

In order to counter-balance this structural discrepancy, the EU has sought other financial instruments as alternatives. In the course of 2009 it has started to front-load specific funds for countries in the western Balkans. More specifically, the EU is using one of its core financing instruments –namely IPA– to delivery funding assistance to non-EU members in the region.⁵

⁴ Jens Bastian, Guest column: “No time to dither over policy options”, *Financial Times*, 18 June 2009.

⁵ 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.

To illustrate, IPA resources earmarked for capacity building projects are being re-directed as direct budgetary support means. Serbia received 100 million euros 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”⁶

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

In terms of volume and macro-economic impact these EU measures are primarily of symbolic importance. But they do underline that the EU recognizes the institutional discrepancy between EU members and non-members as regards funding availability. In consequence, it is prepared to support potential candidate countries in the western Balkans by other means from its vast toolbox. To further underline this approach, the EU is also providing a credit line to Serbia in 2010 in two tranches of 100 million euros each.

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 IFIs and the foreign parent banks owning local subsidiaries across Southeastern Europe.

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

⁶ 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.

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.

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. 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.

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 jumped to 524 million euros from 108 million euros, reflecting a steep rise in non-performing loans in the first half of 2009, mainly in Ukraine, Russia and Hungary. On 30 June 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 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 2 below).

Table 2: Credit Ratings in Southeast Europe mid-2009

COUNTRY	CREDIT RATING (STANDARD & POOR'S)
Albania	None
Bosnia & Herzegovina	B+
Bulgaria	BBB*
FYR Macedonia	BB
Montenegro	BB+
Romania	BB+
Serbia	BB-

** 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.*

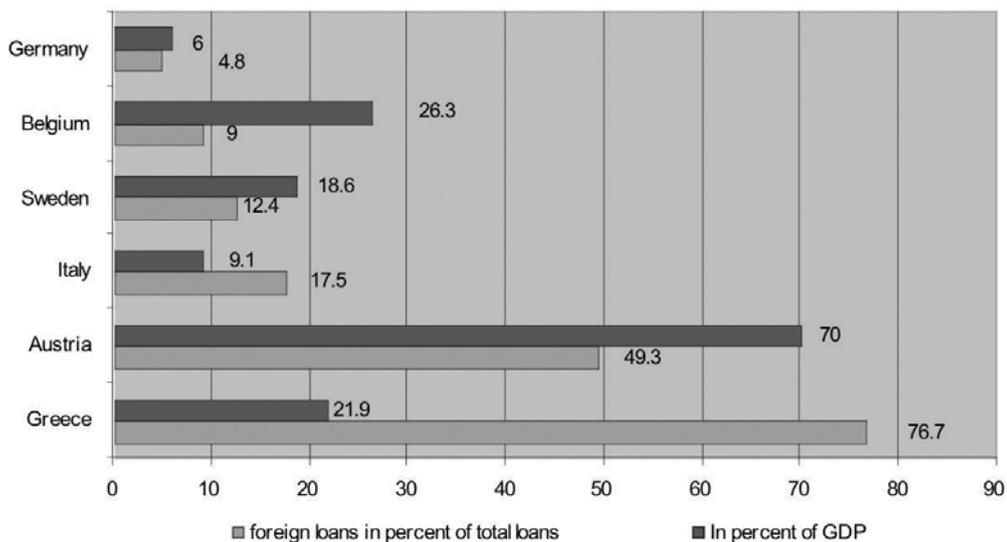
Any manifest funding problems emerging for certain banks would immediately trigger a currency crisis in that given country and a flight of foreign capital. Such a scenario would set off a second wave of sharp output decline, curtailing any upside that may have been in the economic pipeline during the 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 has fallen 20 percent against the euro since its peak in August 2008.

Any forecast for the timing and scope of economic recovery in Southeastern 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.

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.

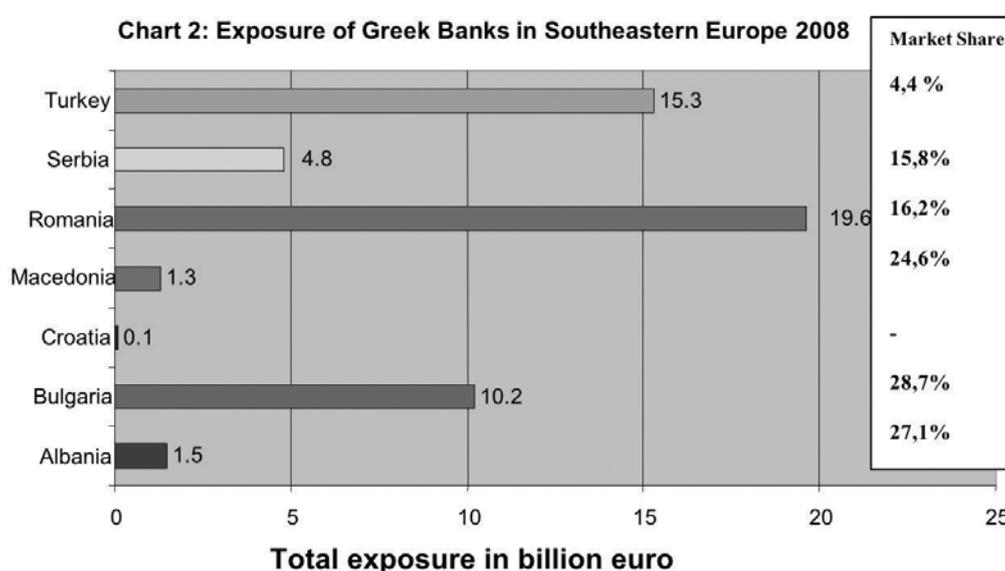
Chart 1: Foreign Bank Lending in Central & Eastern Europe 2008



As the chart above illustrates, Greek 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. 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 proactive lending strategy during the past decade.⁷

⁷ The countries include Poland, Russia, Czech Republic, Turkey, Hungary, Romania, Croatia, Slovakia, Ukraine, Bulgaria, Estonia, Latvia and Lithuania, see *Kathimerini*, 7 March 2009.

The chart below 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.



Source: *Kathimerini*, 07.08.2009

The 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 Southeastern 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. Two months later, they followed up this commitment with additional liquidity provisions to their local subsidiaries. They voluntarily agreed to increase the capital ratios of their subsidiaries from the statutory eight percent level to ten percent for the duration of 24 months until mid-2011.

Together, the nine banks hold a market share of 70 percent 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.⁸

Table 3: EBRD Capital Support to UniCredit in Central, Eastern, Southeast Europe

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

Source: EBRD Press Release, 7 May 2009, “EBRD and UniCredit join forces to support businesses across Eastern Europe.”

Such joint engagement is supplemented by Europe’s main development bank –the EBRD– to extend lending totaling 433 million euros into Central, Eastern and Southeast European subsidiaries of the Italian bank UniCredit (see Table 3 above). UC is the single largest financial investor and the biggest banking group (by assets) in the three regions.⁹ The May 2009 agreement with UniCredit is the largest in volume to date. The EBRD also recently extended similar loan

⁸ 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”.

⁹ UniCredit has a network of over 4,000 branches in 19 countries of central, eastern and southeastern Europe. Since the mid-1990s UniCredit has invested about 10 billion euros of equity in the three regions and has approximately 85 billion euros of total customer loans in the regions.

facilities to Banca Comerciala Romana (BCR), a Romanian subsidiary of the Austrian bank Erste Bank.

As these various external funding initiatives illustrate, the EBRD is 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 countries by 50 percent, to three billion euros.

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 euros to assist Serbia with external funding for small and medium-sized enterprises and priority infrastructure projects. The picture that is gradually emerging in Central, Eastern and Southeastern 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.

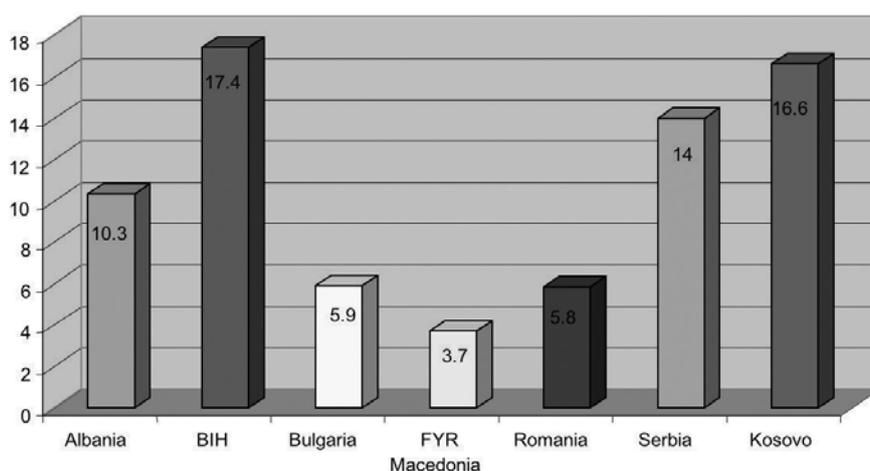
Social Implications of the Economic and Financial Crises

The economic contraction in Southeast Europe during 2009 is reordering citizens' expectations about their future expectations in areas such as employment, wages, government-funded pensions, and the availability of credit as well as welfare services. In practice, austerity programs are gradually rippling down the social hierarchy, with adjustments taking place in every segment of society. Anxiety about and opposition to policies reducing social security and welfare services are running high in the region.

The rescue package from the IMF and other IFIs include painful conditionalities that will have to be met with budget cuts and public spending limitations during 2009-10. The measures are primarily affecting public sector employees, reduced funding for cities and local administration as well as retirement benefits. The social implications of such conditionalities are dire and subject to public controversy. Take Serbia as an example:

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 euros a month).

Graph 5: Remittances in % of GDP 2008 in Southeast Europe



Source: World Bank estimates based on the International Monetary Fund's Balance of Payments Statistics Yearbook 2008 and World Bank, Migration and Remittances Fact Book 2008. Data for Kosovo is from Kosovo's Institute for Advanced Studies, 2008.

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 and Herzegovina, 16.6 percent in Kosovo and over ten 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.

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 euros (420 dollars) 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 two dollars a day.

The regional impact of declining remittance inflows in Southeast 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.

The flip-side of declining remittances by migrant workers is that the tide of laborers is starting to flow in reverse in Europe. 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.¹⁰

Equally, key areas of social and welfare policy making will have to be revisited by governments, trade unions and employer associations; albeit reluctantly and frequently imposed through external conditionalities of IFIs. Three such contentious issues are:

- (i) raising the retirement age,
- (ii) changing the indexing formula for pension benefits,
- (iii) broadening the tax basis in all countries (personal income tax, VAT and corporate taxation).

Of chief concern for countries in southeast Europe is how far they can politically afford to comply with IMF conditionalities for belt-tightening measures needed for the states to regain their fiscal footing. As Table 4 (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 downturn's socio-economic ramifications.¹¹

¹⁰ Incentives to leave are not restricted to more prosperous west European countries. The Czech government announced in February 2009 that it would pay 500 euros and provide one-way plane tickets to foreign workers willing to return home.

¹¹ 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 4: Political Dynamics of the Economic Crisis in Central, Eastern, Southeast Europe

Country	Time	Reason
Latvia	February 2009	Resignation of government
FYR Macedonia	March 2009	Presidential candidate of government elected
Hungary	March 2009	Resignation of Prime Minister
Czech Republic	March 2009	Vote of no-confidence
Montenegro	April 2009	Ruling government re-elected
Albania	July 2009	Ruling government re-elected
Bulgaria	July 2009	Government voted out of office

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 Southeastern 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.

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?

Conclusions

All told, the outlook is challenging to say the least. Are there some green shots emerging? Or could we argue that things are getting worse more slowly, bottoming out at low levels? What qualifies under the current circumstances and volatile outlook as improvement? 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. In short, many did not see the crisis coming. Many may either mistake some green shots for a recovery or be all too pessimistic about the initial signs of a turnaround.

The rate of economic contraction in the region is slowing down. Technically, most countries may be moving out of recession in 2009-10.¹² But the coming months are still going to feel very much like a recession to many constituencies across Southeastern Europe. In the coming years the trend growth rate of most countries in Southeast Europe will be much closer to two to four percent than in the region of five to eight percent as during the past five years.

In addition, concerns about the medium-term solvency of governments in the region 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 and Herzegovina will face repayment 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.¹³

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,

¹² According to the EBRD's May 2009 GDP forecast in 2010, Bosnia & Herzegovina and Montenegro are expected to continue registering economic contraction next year.

¹³ 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.

are irate. Ample opportunities to use elections as a tool for political punishment have already been taken advantage of (see e.g. Bulgaria) and will continue to present themselves in the coming months.

Judging from the European Parliament elections in June 2009 to presidential and general elections in 2009-10, governments across the region must be uneasy about their re-election prospects.¹⁴ The political consequences of the economic crisis could trigger a backlash against the further course of EU integration, in particular against Croatia and Turkey as accession countries.

Two decades after the collapse of the Eastern block, the countries of 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.

But the current challenges of the region defy easy categorizations and comparisons. Are the economies in Southeast Europe now discovering their limits, i.e. limits of autonomous development, constraints of economic integration and the restrictions of crisis management when confronted with the magnitude of such economic and financial crises? 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, policy responses lagged behind 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.

A broader re-examination by public authorities of government's role in the economy will have to take place in Southeast Europe. This may include exploring new ways to expand the government's responsibilities, in particular regarding

¹⁴ Bulgaria held a general election in July, just a month after the election of a new European Parliament. The opposition candidate, the former Sofia mayor Mr Boiko Borissov and his party GERB comprehensively defeated the governing Socialists.

- (i) the creation of additional fiscal space, and
- (ii) their crisis management / reaction capacity and regulatory expertise.
- (iii) 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.

On the institutional side of fiscal policy making delicate questions await new answers. How can government tax codes be improved, broadening the corporate and personal income tax base? In the past years countries in the region have sought to outdo each other with flat tax regimes that severely curtailed government spending alternatives in the medium to long-term.

Moreover, the effects of the crisis also invite to reconsider what are going to be the sectors of the economy that give Southeastern Europe sustainable GDP growth without having to resort to expensive, multi-year bail out programs from external anchor institutions such as the IMF, the World Bank, the EBRD and the EU. This endeavor includes re-thinking how governments in the region can generate fiscal stimulus without having to rely so heavily on IFIs. In a word, what growth model do they decide to apply in the coming years?

Finally, the social implications of the crisis require re-evaluating the importance of a strong social safety net, e.g. keeping health care despite losing one's job. This is exactly the time when the importance of having a decent social safety net is driven home to everybody in Southeast Europe.

This is a time for new ideas, bold thinking and original perspectives. In summary, thought-provoking choices about the nature of their political economies lie ahead and need to be reconsidered in the countries of Southeast Europe.