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Falling Behind Again?
Southeast Europe and the Global Crisis

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Summary
As the global crisis deepens, the economic outlook for the region of southeast Europe darkens. The crisis resistance of countries in the region has not been tested before on such a scale. Furthermore, their institutional arrangements remain distinctly fragile. Confronting the crises will require bold and coordinated policy initiatives, sustained international support and the recognition of its social implications.

Introduction

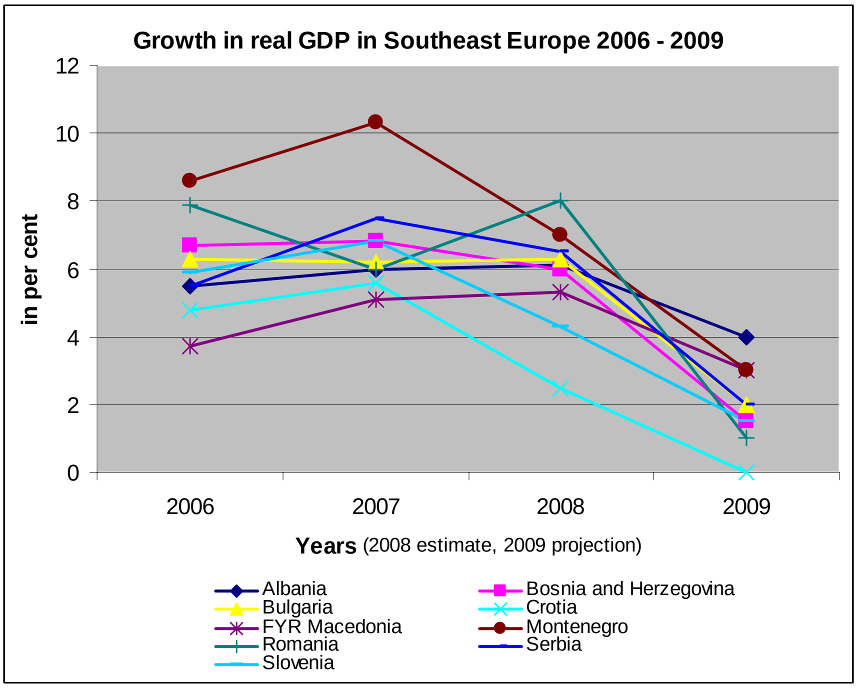
The global financial and economic crises mean tough times ahead in all hemispheres. The crises will not detour the Balkans. The downturn is proving a major test for political and economic institutions that have little to no experience with such a magnitude of challenges. Much is at stake for the region's short to medium-term outlook. The economies in the Balkans are facing a serious stress test against the unfavourable backdrop of plummeting economic activity, increasing fiscal problems and worries about the health of their banking sectors.

Moreover, the Balkan economies are not immune to the deteriorating conditions in neighbouring countries, in particular the serious problems Hungary and Greece are currently facing. Spill-over effects cannot be excluded, e.g. for export markets, cross border trade relations, foreign direct investment and financial sector intermediation. The cascading aspects of the twin crises are gradually filtering through to different sectors of economic activity and segments of society.

The economies in the Balkans are facing a serious stress test against the unfavourable backdrop of plummeting economic activity, increasing fiscal problems and worries about the health of their banking sectors.

The impact of these crises on individual countries is already being felt. Most directly, this is reflected by a rapid return of multilateral financial institutions (IFIs), in particular the *International Monetary Fund (IMF)*, to the region. They are providing emergency lending with controversial conditionalities attached to it. Individual countries that only recently heralded the fact that they could "stand on their own feet" are now (re-)turning to multilateral financial institutions for emergency funding.

What are the lessons to be learned – and applied – from these developments? The manner in which countries in the region will confront the crises will be telling for two reasons. For one, it will highlight if they pursue individual paths for crisis management or are attempting coordinated approaches to wither the storms. The second aspect concerns the crisis resistance of institutional arrangements in the region that remain distinctly fragile. The stability of political and economic institutions within these countries and new regional cooperation arrangements that have been emerging during the past years will be severely put to the test.



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Economic manifestations of the crises

Because of the Balkans' increased integration into the west European economy, the crisis' impact will be felt in a wide area of economic and financial sector developments. As the global crisis deepens, the economic outlook for the Balkans is darkening. After years of impressive GDP growth rates, at times with concerns being voiced of overheating, the countries must now wind back their annual growth forecasts.

The *European Bank for Reconstruction and Development (EBRD)* adjusted downward its average growth predictions for every single country of the region. (http://www.ebrd.com/new/ressrel/2009/090127.htm).The variations of this adjustment are stark and continue to be in flux. Bosnia and Herzegovina is projected to only grow by 1.5 percent in 2009, Romania by one percent and Croatia's GDP outlook for 2009 is seen as flat; i.e. zero growth (see previous graph).

For countries that had grown between six and even up to ten percent annually during the past years, such projected growth forecasts for 2009 are nothing less than an economic nightmare! In total, south-eastern Europe is expected to grow by 1.5 percent in 2009, down sharply from the 7.3 percent estimated for 2008. Such growth levels as in 2008 were based on strong domestic demand fuelled by excessive credit growth in household consumption and mortgage services. A sharp slowdown to 1.5 percent in 2009 signifies that consumer demand is radically re-adjusting downward, with credit availability frozen and debt repayments becoming the order of the day.

Migrant workers' transfers in the Balkans constitute a major economic factor. In 2007 remittances as a share of GDP reached 17.2 percent in Bosnia & Herzegovina, 16.5 percent in Kosovo and 10 percent in Albania.

Table 1: Workers' Remittances in the Balkans in 2007 and 2008* (US $ million)

Country	2007	2008	In % of GDP (2007)
Albania	1.071	1.071	10.1
Bosnia & Herzegovina	2.520	2.600	17.2
Bulgaria	2.086	2.200	5.7
Macedonia, FYR	267	315	3.6
Romania	8.533	9.000	5.6
Serbia + Montenegro**	4.910	5.100	13.8
Kosovo***	430	450	16.5

* Data for 2008 are World Bank estimates.
** The World Bank does not yet provide disaggregate data for both countries after Montenegro's independence in 2007.
*** Data for Kosovo is from Kosovo's Institute for Advanced Studies, 2008.
Sources: World Bank estimates based on the International Monetary Fund's Balance of Payments Statistics Yearbook 2008 and World Bank, Migration and Remittances Factbook 2008.

Remittances slightly increased in 2008. But the economic crisis will leave its mark on migrant workers' continued ability to transfer such amounts back home. Many of these labourers are employed in sectors adversely affected by the recession in their host countries, in particular in car manufacturing, construction and household work. A decline in remittances from relatives working abroad will affect families and their income expectations during 2009. It will equally impact on countries' foreign currency holdings, medium-term budgetary planning and the financing of high current account deficits.

The full force of the global economic downturn is beginning to engulf the region in a variety of ways. Just consider the following indicators at different levels of economic activity:

1. Between 2000 and 2008 the ratio of foreign debt to GDP rose from 45 percent to 51 percent in central, eastern and southeast Europe.
2. Foreign direct investment (FDI) is expected to decline sharply in 2009. The *Economist Intelligence Unit* predicts a decrease by 46 percent between 2008 and 2009, with FDI considerably declining in Romania, Montenegro, Serbia and Bulgaria.
3. Adding to this conundrum are projections for export market growth in the Balkans for 2009 that spell zero growth for most countries. For all countries in the region the EU is the single largest export destination. But declining exports to e.g. Germany, France, Italy and Austria, due to drastically falling consumer demand in these countries, will adversely affect the economies of the Balkans.
4. Such an outlook constitutes a serious disruption in the real economy. This will immediately be felt in terms of anticipated shortfalls in customs revenue and VAT – two cornerstones of the countries' fiscal consolidation process. Romania, the largest exporter in the Balkan region – east and west – has seen its exporting industries (car manufacturing in particular) severely hit by declining demand from EU countries.

Financial sector implications in the Balkans

Let us turn our attention to financial sector implications of the global credit crisis in the emerging economies of the Balkans. Financial integration has made much progress during the past decade in the region. FDI into the financial sectors has been considerable, notably from Austria, Italy, France and Greece. However, the financial sectors of these countries are still characterized by being bank dominated sectors operating in an environment where cash transactions remain the norm (Bastian 2003).

For foreign commercial banks the decision to expand into the Balkans in the early 1990s was strategic. Their activities have been guided by taking full advantage of the emerging business opportunities, notwithstanding obvious risks involved. As a result of this sustained investment drive, they have established large branch networks and considerably expanded their service portfolio. But what they will do next under the current circumstances in their domestic and subsidiaries' markets will have significant implications for financial sector development in the Balkans.

Data from the *Bank for International Settlements (BIS)* shows that east, central and southeast European banks accumulated total external liabilities to banks that report to the BIS of USD 1.657 trillion as of September 2008. USD 1.511 trillion of that total amount is owed to euro-zone commercial banks.

Translated into potential risk factors this level of liabilities highlights how much euro-zone banks are exposed to emerging Europe through a rapid accumulation in assets in the region. According to Brown Brothers Harriman's calculations, countries with high emerging market exposure relative to GDP include Austria (82 percent), Switzerland (53 percent), the Netherlands (49 percent) and Belgium (42 percent).

Countries in the Balkans are finding themselves caught in a disturbing policy bind: credit is available, but only at punitive short-term rates. Further borrowing raises broader questions of solvency and levels of indebtedness. The risk premium demanded by lenders for extending credit to these countries has grown appreciably during the past six months. Spreads on the ten-year government debt of Bulgaria, Romania and Serbia have widened sharply. Rating agencies are paying particularly close attention to the fiscal positions of these profligate five. Pressure from the bond markets is matched by adverse developments in the foreign exchange markets.

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In the Balkans foreign banks and non-bank financial institutions (e.g. insurance companies) have over the past decade accounted for more than half of the corporate lending market and two thirds of the home-loan business. The countries are strongly dependent on foreign currency lending, which has mainly been provided by foreign (parent) banks to their southeastern subsidiaries. With the credit freeze domestic banks and local companies are finding it increasingly difficult to refinance their foreign debt holdings.

The *Institute for International Finance (IIF)* issued a report in January 2009 warning that the outlook for private capital flows to emerging markets deteriorated significantly during 2008. Private capital flows are projected to fall to USD 165 billion in 2009 from USD 466 billion in 2008! The region most directly affected by the decline in foreign capital flows is Emerging Europe, i.e. central, eastern and southeast Europe.

Foreign banks from Austria, France, Italy and Greece contributed to the mounting problem through a speedy, if not irresponsible expansion of credit to households. But when credit markets freeze, as is currently the case, existing foreign currency loans become a cocktail waiting to explode. Many local domestic currencies have devalued *vis-à-vis* the euro and the Swiss franc, making the repayment of these loans more expensive for the (mortgage-) holder and the default risk higher for the issuing banks, most of which are foreign-owned.

It is in the self-interest of foreign banking institutions operating in the region to avoid the public impression that due to a lack of foreign funding from a parent bank neighbouring subsidiaries could be in dire straits as regards their availability of capital resources.

The immediate result of such an impression, and it is enough that it is perceived as such in public, is to trigger a run on specific banks from worried depositors. This scenario of panicked hoarding is not at all unrealistic as recent events in Bosnia testified. In October 2008 tens of thousands of people lined up at commercial banks and demanded their deposits. To date, only one bank in the region had to be rescued through government intervention. In December 2008 the privately held *Prva Banka* in Podgorica was bailed-out by the Montenegrin government.

We can observe that foreign bank lending is contracting as foreign governments start to either incentivize and/or oblige commercial banks to first lend to domestic businesses and households because there are receiving government resources to aid the financial industry in their respective home markets. In other words, the critical link between parent bank and its subsidiary across the border is being put to a severe test of financial cooperation. While they have not abandoned their subsidiaries abroad, they are nevertheless tightening credit availability, re-emphasizing deleveraging and starting to hold their counterparty on a much shorter leash.

A lack of credit availability (loan guarantees, overdraft facilities etc.) from foreign institutions is particularly dire when it is also affecting successful firms in the region. The consequences of restrictive financing for international commerce in the Balkans are a telling example. Export capacity in the region is critically dependent on trade finance being provided by local banks at affordable rates. But local credit availability is currently drying up. The interest rate on export finance loans to Bulgaria, Serbia or Romania has gone from 1.2 percent above Libor, a floating benchmark rate set in London, to about six percentage points higher.

Simultaneously, spreads in international bond markets are widening. Countries in the region that must turn over a large amount of foreign currency debt in 2009 – e.g. Romania, Bulgaria and Serbia – risk running into substantial refinancing difficulties. In 2008 Bulgaria's external debt-to GDP ratio reached 97 percent, while Romania's was 61 percent. Even more worryingly for both countries is their short-term debt-to reserves ratio. Bulgaria's is 86 percent, while Romania's is 96 percent. In other words, Romania would have to use all of its available foreign currency reserves in 2009 if it were to service its entire short-term debt repayment obligations. Under these severe conditions the spectre of default looms large.

The Greek factor in the Balkans

Greek banks' expansion in the neighbouring countries took place in record time and at a volume of investment which was unprecedented for Greek financial institutions operating abroad (excluding Cyprus). Organic growth, which first dominated the investment strategy, was increasingly overtaken by aggressive expansion and expensive acquisitions in the late nineties, early 2000s.

For over a decade Greece enjoyed a rising trade surplus with countries of the region, only to recycle much of this surplus back into neighbouring economies through FDI in commercial banks, telecommunications and the construction and food industries. Geographic proximity and the willingness to defy risk assessments made a huge difference during the past decade in giving Greek companies an impetus to pro-actively invest in the emerging markets of the western and eastern Balkans (Bastian 2004).

But the importance of such geographical proximity also holds true *vice versa*, with rather negative implications for Greece's neighbours. Economies in the Balkans are specifically affected by external conditions in their neighbourhood. This is particularly true for bi-lateral trade relations, extension of credit for trade finance and

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foreign direct investment levels between this region and Greece.

Under the present circumstances of global financial riptide Greek banks' strong positioning in the Balkans may be viewed as an element of excessive risk-taking combined with increasing levels of uncertainty. What initially appeared to be a blossoming investment in their palm may currently turn out to feel more like a thorny issue in their hand.

The more Athens is caught in an explosive mix of economic, financial and political crises during 2009, the short to medium-term consequences are immediately felt next door. In the financial sector Greek banks have started to retrench and focus on home markets, thereby curtailing and/or putting on hold their business expansion plans in the region.

More specifically, Greek financial institutions are curtailing their investments and downsizing loan portfolios in neighbouring countries. This constitutes geographical proximity in reverse for Greece's Balkan neighbours. The concern in Tirana, Skopje, Belgrade, Sofia and Bucharest is that parent institutions will use their subsidiaries in the region as refinancing instruments for the improvement of their capital requirements in the home market.

The Greek central bank publicly “advised” domestic financial institutions that receive funds from the government's € 28 billion bail-out package to be “more prudent” about extending funds to their Balkan subsidiaries. Putting pressure on banks to favour lending at home does not only apply in Greece. Such a dilemma has no easy solution. The French President Nicolas Sarkozy promised USD 7.8 billion in state aid to French car manufacturers in February 2009, while calling on them to “repatriate” jobs from other, less expensive EU countries, specifically citing the Czech Republic.

But the consequences of such an approach, even if undertaken reluctantly, are manifold and possibly self-defeating. Greek banks' downsizing of their loan portfolio in neighbouring countries would leave the more than 8.000 Greek businesses investing in the region without the level of financial services they have come to expect from Athens-based parent institutions.

Furthermore, Greek financial institutions have greatly benefited during the past 15 years from their investments in southeast Europe. This applies not only to their profitability levels, but equally to the internationalization of their business operations. As a result of their expansion in the Balkans Greek banks have become much more competitive abroad, in particular *vis-à-vis* their major counterparts from Austria, France and Italy operating in the region. In 2008 Greek banks' market share in the financial sectors of the Balkans had reached 20 percent.

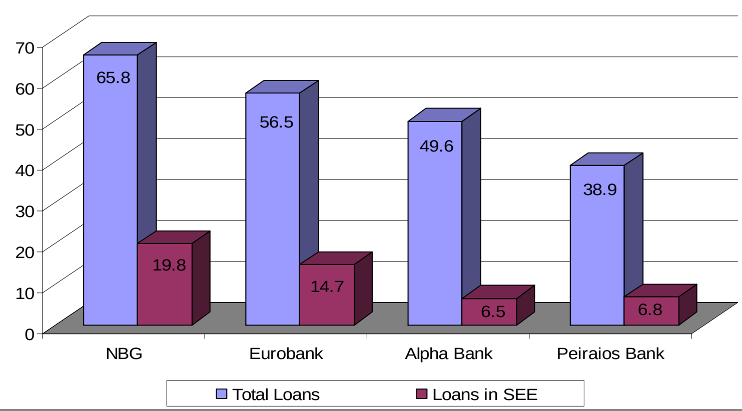
This improved competitiveness is further based on a long-term investment strategy that has weathered storms before as in Romania and Bulgaria under conditions of hyperinflation in the mid-nineties or in Albania after the collapse of so-called pyramid schemes in 1996.

Greek financial institutions should think twice before surrendering their hard-fought competitive edge in southeast Europe for the short-term price of domestic consolidation. They are aware that their subsidiaries in the region depend on the availability of large volumes of foreign bank capital. However, the solution to this challenge cannot solely depend on the continued support of subsidiaries through liquidity transfers from their foreign parent banks. This is why they are lobbying with other banking institutions from Austria, France and Italy for international assistance to the financial sectors of the region and the implementation of coordinated measures by IFIs.

International coordination instead of abandonment

As Western financial institutions downsize their operations or put on hold their investments the spectre of being left out in the cold looms large for southeast Europe. Under the current circumstances emerging economies in the Balkans are being frozen out of credit markets. When financial institutions in southeast Europe are experiencing increasing difficulties to attract foreign currency loans on international capital markets or have funding blocked from parent banks in third-party countries then they are being effectively side-tracked. Put otherwise, a new form of de-coupling risks taking shape in the Balkans, namely derailment and abandonment.

Table 2: Loan Exposure of Greek Banks 2008 (in billion €)



Retrenchment may currently appear politically opportune. But what would speak in favour of coordinated international approaches in the Balkans? For one, countries with a credible track record of FDI in the region have a long-term interest in maintaining financial networks in neighbouring markets. These have served them well to attract new business opportunities during the past decade. Furthermore, it is in the self interest of foreign banking institutions operating in the region to avoid the public impression that due to a lack of foreign funding from parent banks neighbouring subsidiaries could be in dire straits as regards the availability of capital resources.

The urgency of the matter was reinforced when six European banks that are heavily invested in southeast Europe demanded supporting intervention from the European Commission in December 2008. More specifically, *Raiffeisen International Bank Holding AG* and *Erste Group* (both from Austria), *UniCredit SpA* and Intesa *SanPaolo SpA* (both from Italy), *Société Générale* from France as well as *KBC Groep* from Belgium asked the Commission to consider a support programme for the banking sectors in individual countries of the region.

This line-up of west European commercial banks is a "who's who" of investment in the banking sectors of central, eastern and southeast Europe. *UniCredit* controls the largest commercial banks in Poland and Bulgaria. *Erste Bank* controls the largest institutions in the Czech Republic, Slovakia and Romania. *Intesa* is the majority owner of the largest bank in Serbia, while *KBC* owns the largest bank in Hungary. Meanwhile, *Raiffeisen* has the largest network of branches across the three regions and in Russia and Ukraine.

It is thus not by coincidence that this set of countries is leading the call for coordinated EU intervention. The aforementioned six commercial banks are asking the Commission to consider a package that should include the following elements:

(i) making available foreign currency loans,
(ii) guaranty of deposits provided by IFIs, and
(iii) strengthen the capital basis of foreign-owned banks.

Turning to the Commission and IFIs for financial support suggests that the current banking problems in the region are real and the outlook so challenging that additional, third-party intervention is deemed necessary.

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The (quick) return of the IMF to the Balkans

As foreign conditions deteriorate and domestic economic challenges increase, the only alternative available is a rather ambiguous option, namely calling (back) IFIs. This renewed appreciation for multilateral financing institutions will not receive unconditional popular support.

In January 2009 the IMF provided Serbia with a lending facility of USD 530 million. But the more pressing concern may rest with those countries that have yet to acknowledge that their "march to Canossa" is imminent. The two most obvious suspects in the region are the newest EU members, i.e. Bulgaria and Romania. Bucharest may need external funding from the IMF in the second half of 2009 when a significant part of its short-term foreign debt repayment obligations are due.

Country	Timing	Volume (USD)	IFIs
Hungary	October 2008	25.1 billion	IMF, WB, EU
Ukraine	November 2008	16.4 billion	IMF
Latvia	December 2008	8.8 billion	IMF + EU
Belarus	January 2009	2.46 billion	IMF
Serbia	January 2009	530 million	IMF

Source: www.IMFofg/external/country/index.htm

Next in line seeking financial assistance could be Bulgaria. Sofia's current account deficit sky-rocketed to 24.3 percent of GDP in 2009. This level represents the highest gap in the EU. Such levels of external exposure make Bulgaria vulnerable to the adverse effects of large capital outflows. The Bulgarian Central Bank reported that the C/A deficit rose from € 6.3 billion in 2007 to € 8.28 billion in 2008. FDI dropped to € 5.3 billion and only covered 65.6 percent of the C/A deficit.

The IMF's intervention is a remarkable turn of events for the international lender. Only a few years ago the *raison d'être* of the institution was being called to task. Discussions about its mandate, scenarios for potential mergers with other IFIs, downsizing the IMF after its retreat from countries that used to call on its services, albeit involuntarily, grew plentiful. In a word, the future relevance of the IMF was front and square on the agenda.

Consider the following development. For the first time since the beginning of the economic and political transition process in the early 1990s the countries in the Balkans managed to terminate their individual assistance programmes with the IMF. From 12 countries in southeast Europe at the peak period in 1994-97, the number of IMF programmes in operation declined to three in 2007, all of which expired in the course of 2008.

The symbolic importance of the IMF "departing" from these countries over time was not to be underestimated (Bastian 2008). The timing and urgency of return to the region could equally not have been more symbolic. Just when it was ready to "call it a day" in Serbia, the authorities in Belgrade were obliged to agree a new USD 530 million lending facility with the IMF in January 2009.

For countries having sought emergency lending from the IMF and other IFIs during the past six months, and those waiting in line with no alternatives available, it must seem like a nightmare replay. After all their reform achievements, with enormous social costs and political capital invested during the past 15 years, they are now again faced with having to navigate profound crises with uncertain outcomes.

How will the IMF use its new leverage in the region? Can it adopt a new role, or even use its lending intervention to identify a new mission, applying lessons learned from past operations? The consortium of IFIs that put the rescue package together for Hungary reflected an innovative, multilateral approach to the worsening financial situation in Budapest. The coordinated intervention between three institutions may also signify a changed focus regarding demands for and implementation of austerity measures on the part of the IMF and others IFIs involved in the bailout operation.

But it may be early days for praise and a major difference has to be borne in mind. Hungary is an EU member, with other levels of institutional integration than Belgrade, Podgorica, Skopje or Tirana. This difference highlights a major drawback for non-EU members in the Balkans. Their only route available for possible bailout operations may be IFIs, while the EU's hand for immediate financial intervention through its lending institution – the EIB – is rather limited for non-members. Put otherwise, emergency lending arrangements to Balkan countries may raise the very concerns they are intended to calm: that the crisis threatens to split the region into rival camps.

It would be a critical signpost if a new demarcation line is drawn by IFIs for countries in need in the Balkans. How rescue packages are structured according to the needs of the country may essentially depend on a limited set of available alternatives. The EU cannot assist non-EU member countries in the Balkans in the same manner as it did in the case of Hungary. The IMF, World Bank, EBRD and the EU have the structural depth and critical mass of capital resources to put coordinated rescue programmes for the Balkans together. But they may differ among each other in the execution of details or levels of conditionality to be applied.

Social implications of the crises

The social implications of the global economic downturn are already manifesting themselves in riots on the streets of Sofia. The demonstrations in Bulgaria in January 2009 were further fuelled by popular anger over the gas dispute between Russia and Ukraine. The protests articulated allegations of endemic corruption among the country's authorities and voiced widespread discontent at the perceived economic incompetence of the government in light of the deepening crises.

To date, street unrest, in particular when turning into popular anger, is rather exceptional in the region, despite strongly visible economic cleavages and social inequalities. But the emergence of civil unrest could spell trouble on the horizon. The demonstrations may signal an early and unprecedented popular backlash against the sustainability of reform policies subsequently associated with painful austerity programmes. This is where the economic crisis can develop into a crisis of democracy in societies of the Balkans.

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It remains to be seen whether the conditionalities imposed by the economic crisis and the carrot-and-stick elements of international support programmes are politically tolerable in societies where popular expectations of a growth dividend are persistently articulated. The barometers of social inequality in the Balkans are only bound to rise as a result of the economic calamities. Neither can political and social tolerance for the pains of reform be unloaded – as in the early stages of transition in the nineties – on the legacies of communist times. Today the expression of public anger manifests itself here and now on the street of Sofia and Belgrade, or in bank runs in Sarajevo and Podgorica.

Under these conditions muddling through will not be good enough. From a crisis of democracy to failing institutions the path may not be very wide in Belgrade, Skopje, Tirana, Podgorica or Sarajevo. The *status quo* cannot be kept on life support through emergency funding, stand-by agreements and deficit spending alone. The repercussions of these pressures are also affecting the stability of democratic institutions and the sovereignty of governance.

The global economic and financial crises also serve as a magnifying glass to identify those countries in the region that have delayed structural reforms and the implementation of sustainable macro-economic policies over the past decade. Further foot-dragging is not an alternative since the economic downturn will vigorously expose reform deficits and delays. Rather, the crisis should be read as an opportunity to implement outstanding reform agendas.

What needs to be done?

The economic and financial crises reinforce the importance of governments' capacity to act swiftly and possibly jointly in order to confront the crises' dynamics. However, the set of available alternatives is limited. Balkan economies cannot export themselves out of the emerging problems. Nor can they rely on compensatory revenue streams from oil and gas resources. One possible shield that can temporarily serve as a buffer is the countries' higher ratio of agriculture as a share of GDP (compared to Western Europe).

Furthermore, the region's options for stimulus packages are restricted because of fiscal constraints. The level of public debt in countries of the region *de facto* excludes further borrowing unless governments are prepared to pay exorbitant interest rates on international capital markets. Hence, authorities in the Balkans lack the resources to support financial institutions. They cannot introduce deposit guarantees nor inject huge amounts of liquidity into ailing companies. Consequently, spending projects are being cancelled and infrastructure investment plans shelved.

Even the currency peg in Bulgaria, which offered stability and predictability for over a decade to authorities in Sofia, has lost its lustre under the conditions of the economic and financial crises. Fiscal policies cannot be loosened without calling into question the sustainability of the peg. With its sky-high current account deficit, Bulgarian authorities risk a currency crisis if they continue to peg the lev to the euro. Bulgaria, Estonia, Latvia and Lithuania have all pegged their domestic currencies to the euro. Their current account deficits range between 15 percent and 24 percent of GDP, levels that have historically been associated with a potential currency crisis.

The burden of adjustment must therefore come from other sources. It is sensible policy making to draw up contingency plans for how best to respond. But it is unclear if any such contingency plans exist in the drawers of finance and economic ministries across the Balkans. In the absence of any such options, "Plan B" scenarios must be identified for the unlikely worst. If the ministries cannot deliver because they lack the institutional capacity and administrative expertise then the EU and IFIs must be called to task.

Safeguard lending to the real economy

A key priority must be for policy makers and IFIs to support the region's banking sectors and assist lending to the real economy. More specifically, this approach should include the mobilization of financial resources, using IFI financing as a catalyst for lending to small and mid-size businesses. The single most important policy tool consists in loosening up closed credit markets at affordable rates for the Balkans.

There is no paucity of innovative suggestions to assist countries that cannot afford bailouts and cannot resort (anymore) to deficit spending. In late February 2009, the EBRD, EIB and World Bank joined forces with an IFI action plan that seeks to support banking systems and facilitate lending to the real economy in central, eastern and southeast Europe. In essence, the initiative proposes "shock absorber" funding to strengthen commercial banks and assist SMEs. The joint IFI action plan expects to commit up to € 24.5 billion in financial resources in 2009-10.

What is the ECB doing?

For its part, the *European Central Bank (ECB)* is providing liquidity facilities by establishing so-called temporary reciprocal currency arrangements to support dollar and/or euro liquidity. More specifically, in autumn 2008 the ECB agreed with the central banks of Hungary and Poland to support liquidity operations in these countries. However, their gain is neighbouring countries' pain. While the former two are EU members, neighbouring countries in the Balkans cannot draw on such ECB facilities because they "only" have a stabilization and association agreement with Brussels.

Increase the savings rate

A further instrument deserving increased attention is the household savings rate. Until very recently mortgage holders in the Balkans believed that they were getting richer, because their recently purchased houses were appreciating in value faster than their debts were increasing and their savings – if existent, declining. The surge in asset values across the Balkans has proven to be short-lived. While the real estate bubbles are beginning to burst, the surge in debt is real and long-term.

As 2009 quarterly economic data will become available and highlight deteriorating conditions, those countries in the region that feature a combination of high savings rates and modest (public) debt appear to be better positioned to cushion the recovery process. The truth of the matter is however that none of the countries in the region currently qualify to meet this twin set of conditions.

Household indebtedness is rising because of excessive borrowing during the past years, frequently in foreign currency denominated consumer loans and/or mortgages. The current account deficits of countries as diverse as Bulgaria, Romania, Serbia, Bosnia & Herzegovina and Montenegro speak volumes of societies that lived way over their means while cheap credit was available, but hardly repaid. Now the route to refinance such exposure is closed or exorbitantly expensive!

Promote regional cooperation

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The call for international support for the Balkans also calls to attention if and how the region itself can coordinate its crisis response. Regional cooperation in the Balkans is not yet anchored enough to become an end in itself. To date, emerging regional (economic) cooperation has few institutional resources at its disposal. A number of arrangements such as the *Regional Cooperation Council (RCC)* or *CEFTA* in the area of trade harmonisation have progressed across the region. But this emerging geography of cooperation and coordination faces stern challenges from the global economic and financial crises. Nor have such cooperation initiatives been tested as seriously before.

1. How crisis resistant are cooperation arrangements in light of the economic and financial ramifications for individual countries? Will the demands from multilateral financial institutions such as the IMF, EBRD, World Bank and EIB risk straining such cooperation arrangements because they require country-specific responses at the expense of joint strategies?
2. How can institutions such as the RCC or CEFTA strengthen their economic profile and make their voices heard *vis-à-vis* the IFIs when it comes to formulating strategic recommendations and coordinate policy responses?

How such cooperation arrangements emerge from these crises will inform us about their crisis resistance capacity. They will equally highlight the amount of political capital its participants are determined to spend in order to advance joint causes in a coordinated manner in the Balkans. Under these conditions international support for coordinated solutions is all the more important. International financial institutions such as the IMF, World Bank, EBRD and the EIB have an opportunity at their hands to foster regional cooperation by avoiding unilateral actions.

Conclusions and recommendations

The globalized financial crisis in 2008 and its ever-more visible consequences on economic development in 2009 are not circumventing the Balkans. The impact of the twin crises is gradually making its way through the region. The most visible sign of this development is the return of the IMF as a crisis lending institution. Serbia has already sought financial assistance from Washington. And others such as Bulgaria and Romania are considering, albeit still out of public view, how their case be heard.

Back in 2007/08 the Balkans were receiving praise from the international community for the sustainability of their reform efforts. But in early 2009 they can neither "run nor hide" from the consequences of the global crisis. They are discovering that the reform policies they put in place to make their transition process sustainable are just not good enough in light of the magnitude of the problems. Instead, they have to call in the rescue operators. The lenders of last resort – IMF, World Bank, the EIB and EBRD – have already started to activate their rescue programmes. They will chart the paths to be taken in return for crisis lending, emergency finance options and stand-by arrangements.

However, the thrust of these programmes for the Balkans must not be backward looking. Instead they ought to be focused on the unpredictable path ahead. A word of caution is appropriate here. However grave the current crisis is the economic calamity has not reached a scale like 10-15 years ago in the transition economies of southeast Europe. Then in the early nineties annual GDP declined by double-digit levels in some countries and CPI inflation sky-rocketed to over 700 percent, e.g. in Bulgaria in 1997.

It is thus necessary to keep a sense of perspective when addressing the medium-term economic perspectives of the Balkans. Facile comparisons between now and then may lead to identifying policy prescriptions that are stuck in the past and/or have been discredited in practice. The

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context in which emerging economies of the Balkans operate today compared to 15 years ago is fundamentally different. Back then they were mostly trying to navigate the complexities of the transition process on their own. Today, the gap between them and developed economies has narrowed, both politically and economically. In other words, the level of maturity attained during the past decade will shape the debates on necessary remedies between decision makers on both sides of the aisle.

The institutional geography they have established over the course of the past 15 years has not been built to weather storms of such magnitude. Economic dominoes are falling and an economic philosophy on which many had anchored their transition process is in the process of being comprehensively discredited. To what degree these economies prove to be resilient and the social fabric of their societies remain intact will tell us much about the sustainability of their reform agendas in the medium-term.

We assumed that these countries had reached, even passed the "point of no return". The recent events oblige us to reconsider the foundations of this assumption. What happens when the fundamentals around them are changing under the weight of the crises? When is the tipping point reached that economic instability in the Balkans risks translating into political instability? The economic outlook has deteriorated so drastically that resolving the crises will require bold policy initiatives, sustained international support and the recognition of its social implications. Much is at stake.

In conclusion, the following policy recommendations are proposed:

1. The problems arising in the Balkans underscore the urgency of a coordinated response to the crisis by IFIs. The Joint Action Plan by the EBRD, EIB and World Bank from February 2009 is a step in the right direction. Building on these IFI capabilities, more will need to be done in the immediate future.

2. Competition for a limited pool of resources, but a rising number of potential applicants will be intense. Generosity for the Balkans, while in high demand, will require considerable amounts of political capital over time from private and public sector initiatives. It is not a given that such an investment will mobilize the necessary financial resources. Political determination will play a major role in this complex endeavour.

3. The political fallout from the economic crisis is yet to be decided. The end game will play out in front of us. The political calendar in the Balkans for 2009/10 is filled with presidential and parliamentary elections. They will offer ample opportunities for disenfranchised electorates to use the ballot box as a means of political punishment. Hence, when considering remedies on a case-by-case basis the authorities must seek to incorporate the broader regional picture.

4. The international crisis response to the worsening economic conditions in the Balkans is a work in progress and subject to a division of labour. In light of the challenges posed, the EU is learning to cooperate with IFIs in the region at an unprecedented scale. The EU and the EIB can bring forms of smart intervention and financial leverage to the negotiating table that complement other IFI's own sets of expertise and conditionalities.

5. Apart from its financial assistance toolbox the EU is in a unique position to serve as an external anchor, facilitating coordination and policy dialogue between stakeholders in countries affected by the crisis. The EU is in the process of applying lessons learned from past interventions and assistance programmes in the Balkans. The credibility it has rebuilt over the past years in the region requires deft craftsmanship in the coming months.

II
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Further Readings:

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