

# SEE Spotlight

News, comment and research on south-eastern Europe

Issue No. 1, May 2010

## EDITORIAL

### Editor's Welcome

Welcome to the first issue of a periodical EBRD newsletter – *SEE Spotlight*. The newsletter aims to present in a concise way up-to-date news, comment and research on recent economic developments in south-eastern Europe. It draws on the EBRD's unique experience as the main foreign investor in a region that has made remarkable progress in the past decade but where major challenges still exist.

The newsletter will be published approximately once every 2-3 months. Each issue will provide the following:

- A summary of important recent research on the region, focusing particularly on research emerging from the region itself.
- Charts and comments on high-frequency data economic trends.
- Analysis of important and topical aspects of economic development and reform.

We hope you enjoy this newsletter and find it useful, and we welcome your comments, suggestions and contributions for future editions. Please feel free to circulate among colleagues and other interested parties.

Yours sincerely,

Peter Sanfey (Lead Economist, EBRD)

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**European Bank**  
for Reconstruction and Development

## RECENT RESEARCH

**G. Matković, B. Mijatović and M. Petrović: Impact of the financial crisis on the labor market and living conditions outcomes**, *Centre for Liberal-Democratic Studies, Belgrade, January 2010.*

This paper shows how the crisis in Serbia has led to falling living standards and rising poverty levels. Vulnerable groups have been particularly affected, especially through the reduced availability of informal sector jobs.

<http://www.clds.org.rs/newsite/Impact%20of%20Crisis.pdf>

**J. Bastian: External anchors to the rescue: reaching out in a time of economic and financial sector crises in South Eastern Europe**, *SEESOX, University of Oxford, Occasional Paper No. 10/10, February 2010.*

The author highlights the crucial role played by international institutions in saving SEE from calamity during the crisis. However, the region must prepare for a new era of austerity, and fresh thinking is needed, particularly concerning the appropriate boundary between the state and the market.

<http://www.sant.ox.ac.uk/seesox/occasionalpapers/Externalanchors.pdf>.

**J. Jonas: Fiscal Objectives in the Post IMF Program World: The Case of Albania**, *International Monetary Fund (IMF), Washington D.C., Working Paper WP/10/77, March 2010.*

The study aims to identify ways to ensure prudent fiscal policy in Albania after the country's graduation from an IMF programme in early 2009. Two approaches, the introduction of an expenditure rule and of a debt rule, are discussed.

<http://www.imf.org/external/pubs/ft/wp/2010/wp1077.pdf>

**B. Kaminski and F. Ng: Bosnia and Herzegovina's Surprising Export Performance – Back to the Past in a new Veil but will it last?**, *The World Bank, Washington D.C., Policy Research Working Paper 5187, January 2010.*

This research appraises Bosnia and Herzegovina's unexpectedly strong export performance between 1997 and 2007. Despite an unfavourable business climate and a low level of exports in terms of GDP, firms with foreign participation have been a driving force in expanding and upgrading the export sector.

[http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2010/03/15/000158349\\_20100315165156/Rendered/PDF/WPS5187.pdf](http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2010/03/15/000158349_20100315165156/Rendered/PDF/WPS5187.pdf)

## RECENT ECONOMIC DEVELOPMENTS

**Industrial production is showing signs of life.** After a significant drop throughout most of 2009, industrial production in SEE picked up towards the end of last year and continues to accelerate. However, year-on-year figures are still negative or close to zero in the majority of cases, suggesting that a robust recovery is not yet in place. The hope is for continued growth as production in the metal sectors returns to full capacities and other industries benefit from the rising global demand.

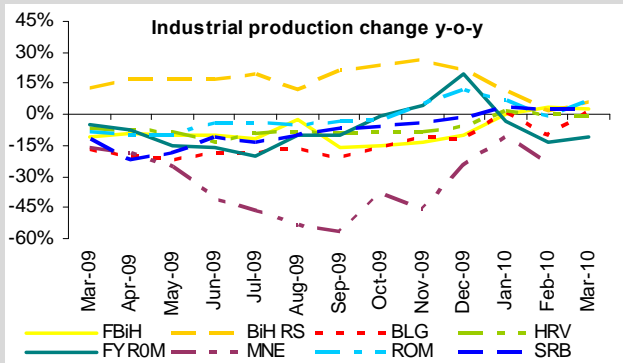
**Exports are starting to recover.** Trade flows in SEE have fallen dramatically in the past year and exports slumped in 2009 by around 20 per cent year-on-year on average. Recent figures, however, indicate a turnaround, with positive year-on-year growth rates in most countries. In Albania, the rebound has been especially strong as a result of a significant increase in exports of electricity.

**Inflationary pressures ease.** Throughout 2009, headline inflation has come down substantially, primarily owing to the fall in domestic demand and a sharp drop in oil prices. Consumer price indices (CPI) moderated in particular in Serbia, while Bosnia and Herzegovina and the FYR Macedonia even entered a period of disinflation in 2009. Recent CPI data indicate that inflation has slightly accelerated again. Overall, however, inflationary pressures are expected to remain moderate.

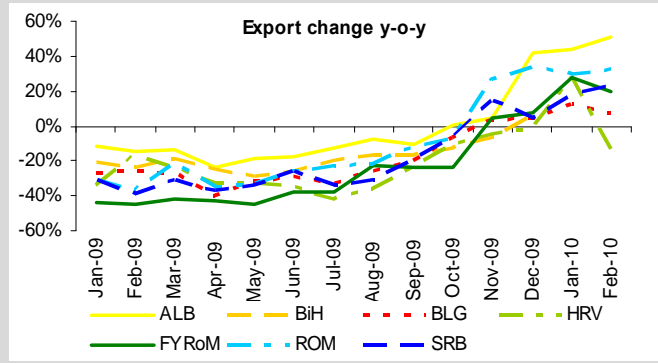
**Risk perceptions have moderated but remain significant.** Credit default swap spreads (CDS) for SEE's largest economies have increased significantly since the beginning of the global financial and economic crisis and peaked in February/March 2009. However, notwithstanding increasing concerns about potential spillover effects from the Greek debt crisis, CDS spreads have fallen greatly, though they remain above pre-crisis levels.

## SELECTED MACROECONOMIC INDICATORS

### Real Economy

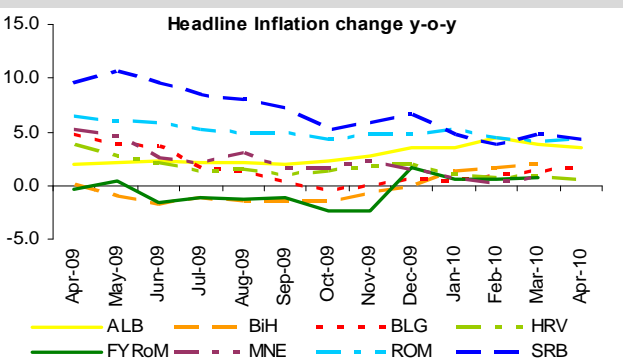


Source: National Central Banks.

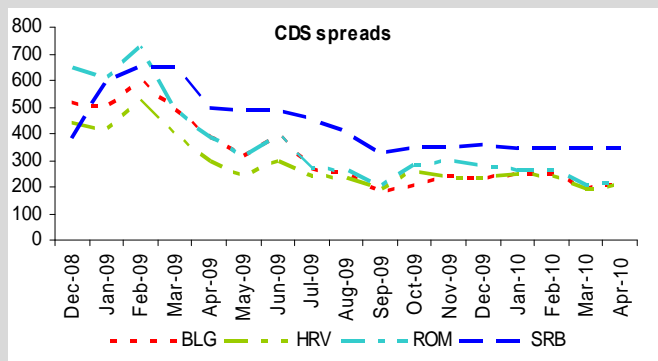


Source: IMF, National Bank of Serbia.

### Inflation and CDS spreads



Source: National Central Banks.



Source: Bloomberg.

## ANALYSIS: WHY IS THE RECOVERY IN SEE LAGGING BEHIND?

On May 15<sup>th</sup> 2010, at its Annual Meeting in Zagreb, the EBRD published its latest growth forecasts for the transition region for 2010 and 2011. The headline figures were mildly encouraging – an average of 3.7 per cent growth this year and 4 per cent next year for the whole region (29 countries). Both figures are below some other emerging markets, but still very welcome after a deep recession (-5.5 per cent) in 2009. But one region stands out as a laggard – south-eastern Europe – with a mere 0.3 per cent growth projected this year, and less than 3 per cent next year. Why is SEE lagging behind other parts of the transition region?

To answer this question, we have to look first at the breakdown by country (see Table 1 below). The first thing to notice is that the more advanced countries – Bulgaria and Romania (both EU members) and Croatia (hoping to join the EU in 2012) – are struggling to emerge from recession. Flash estimates for Q1 GDP figures in Bulgaria and Romania were worse than expected and point to a continuation of the economic slowdown. The Croatian economy also seems to be mired in a deep stagnation, with low confidence, subdued domestic demand and a major reform agenda still ahead to reduce the role of the state. Elsewhere, the outlook is slightly better on average, but not much rosier. Both FYR Macedonia and Serbia may benefit this year from the recovery in global metals prices, and, in the case of Serbia, a major infrastructure programme. Bosnia and Herzegovina and Montenegro should also receive a boost from higher aluminium prices, since this is the main export earner in both countries, but the poor quality of data (no quarterly GDP series, for example) makes it hard to discern clear economic trends. Albania is the most closed economy in the region and has benefited from this fact during the crisis, but it is now looking more vulnerable, especially given the interdependence, mainly through trade and remittance flows, with the Greek economy.

**Table 1: Growth in real GDP**

(EBRD forecasts as of May 15th 2010)	GDP Growth (year on year per cent change)		
	2009	2010	2011
Albania	2.8	1.4	3.1
Bosnia and Herzegovina	-3.4	0.3	1.7
Bulgaria	-5.0	-1.2	3.0
Croatia	-5.8	0.3	1.8
FYR Macedonia	-0.7	2.2	2.5
Montenegro	-5.3	0.1	2.0
Romania	-7.1	0.0	3.0
Serbia	-3.0	2.1	3.2

There are several reasons for the continued poor performance of the SEE region.

- **Heightened risks:** SEE is perceived to be more vulnerable for various reasons, but perhaps most importantly because of the Greek crisis and possibility of spillovers into the region, either through the effects on banks (Greek banks have a major presence in most SEE countries) or because of falling remittances (as noted, this would hurt Albania in particular), or more generally through damaged confidence for the region as a whole. The situation remains highly volatile and the actions of the European Union to calm the situation in Greece and the wider eurozone have not yet had the intended effect. FDI to the region also remains well below pre-crisis levels.
- **Poor performance of the eurozone:** The eurozone is the main export market for all of these countries, and therefore the continued weakness of the recovery there (a mere 0.2 per cent q/q growth in the first quarter) is hitting SEE countries quite hard.
- **Bank deleveraging:** Strong credit growth was a key source of economic growth in SEE in the pre-crisis period. In the rush to grab market share, a number of banks overreached themselves; the level of non-performing loans is still rising although not (yet) as much as feared at one point. Overall the banking systems are in pretty good shape, all things considered, and there has been no failure of a major bank during the crisis. The “Vienna Initiative” – a voluntary arrangement among the main foreign banking groups and IFIs – was particularly important in this regard for those countries with IMF programmes: Bosnia and Herzegovina, Romania and Serbia. However, getting a loan is now much harder than before.
- **Fiscal constraints:** Several countries are under great pressure to keep a lid on public spending and cut back on costly commitments like public sector wages and pensions. Countries currently under an IMF arrangement risk going off-track if they do not deliver on their commitments, but others are scarcely in a better position. The Bulgarian government, for example, has recently agreed to significant belt-tightening in an effort to preserve the country’s hard-won reputation for fiscal prudence. These measures, necessary though they may be, are bound to depress domestic demand.