



**European Bank**  
for Reconstruction and Development

# South-eastern Europe: lessons from the global economic crisis

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## **Summary**

This paper shows how the crisis has evolved in south-eastern Europe (SEE) and why this region was affected by developments that originated elsewhere. It argues that the impact has been better than many feared and that this resilience can be attributed in large part to the mature and sensible reaction of the region itself. It also points to the strong financial support from publicly owned international organisations, and the continued commitment of privately owned foreign companies and banks to the region. The paper concludes that the region is well-placed to take advantage of a future global upturn but at growth rates that are likely to be subdued compared with those seen in the few years before the crisis.

Keywords: Global crisis, south-eastern Europe

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I am grateful to Simone Zeh for her excellent research assistance, and to Marko Atanasovsky, Ivo Germann, Franziska Ohnsorge, Max Watson and Jeromin Zettelmeyer for comments and suggestions on an earlier draft.

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## **1. INTRODUCTION**

During the past decade, south-eastern Europe (SEE) has undergone a dramatic transformation. The extent of the progress in economic development, democratic reforms, regional cooperation, and integration into global economic and financial markets was unthinkable even 10 years ago and is unprecedented in the region's modern history. But 2009 has proved to be a difficult year for all Balkan countries. The financial crisis that began to affect western markets in the second half of 2007 took a while to be felt in SEE, but by the fourth quarter of 2008 it was clear that this region would also face a major economic slump. As of early February 2010, there are signs that output is stabilising. Cautious optimism is being expressed that the worst is over. However, few people expect to see the high growth rates of recent years returning soon.

This paper shows how the crisis has evolved in the region and why it was affected by developments that originated elsewhere. It argues that the impact has been better than many expected and that this resilience can be attributed in a large part to the mature and sensible reaction of the region itself. But it also points out the vital role played by international actors. Not only has there been strong financial support from publicly owned international organisations, but also privately owned foreign companies and banks have refused to rush for the exit, reflecting a major and, so far, largely successful coordination initiative. The paper concludes that the region is well-placed to take advantage of a future global upturn – whenever that might take place – but at growth rates that are likely to be subdued compared with those seen in the few years before the crisis.

The next section describes in some detail the evolution of the main macroeconomic indicators, highlighting the relative resilience of the region and the absence of the kind of output collapses seen elsewhere in the transition region, such as in the Baltic states and Ukraine. It also explains the importance of three contributing factors: the sharp drop in exports; the choking-off of credit; and the effect on remittances. Section 3 shows how the region has responded to the crisis. Most people were totally unprepared for what happened, but despite this, the reaction both of governments and of businesses and workers has been generally mature and appropriate to the circumstances. Section 4 highlights the international dimension – both the direct support from abroad and the spillover effects from the fiscal stimulus and liquidity expansion programmes in advanced countries. Section 5 offers some concluding thoughts and lessons for the future.

## 2. WHAT HAPPENED, AND WHEN?

The origins of the global economic crisis are by now well-known. They can be traced back primarily to an unsustainable credit and housing boom in the United States. The problems in the United States and some other large economies, notably the United Kingdom, became evident in the second half of 2007, and the situation in the leading industrialised economies deteriorated rapidly in 2008. The United States entered recession in Q4 2007 and the UK (Q4 2008), France (Q1 2009), Germany (Q3 2008) and Japan (Q2 2008) were all in recession by early 2009.

By mid-2008 it was clear that the shocks to the global financial system were of a type and magnitude that had not been seen since the Great Depression of the 1930s. At this time, however, the economies of SEE continued to boom. Many people there seemed to be blissfully unaware of, or at least unaffected by, what was happening in the global economy. Banks kept on searching aggressively for market share, both on the liability and asset side. Foreign direct investment (FDI) poured into the region in record amounts, and economic growth continued unabated. Throughout the first eight months or so of 2008 there was a feeling that SEE would be able to escape the worst of the contagion from the crisis. Businesses and governments were still optimistic, after several years of strong growth combined with macroeconomic stability, increasing investment and a sense that the region was on the right path towards integration into the European Union. In fact the main macroeconomic concern in many SEE countries in mid-2008 was not that the global crisis would spill over into their countries, but rather how to tackle inflation, which had started to rise sharply, mainly because of high oil and commodity prices.

The situation started to change noticeably in September 2008. The collapse or nationalisation of several major financial institutions in the US – Lehman Brothers, AIG, Fannie May and Freddie Mac – caused such upheaval in the world economy that everyone realised there would be dire consequences around the globe, and that no country would be immune. Nevertheless, the prevailing wisdom of the time was that there would be a significant slow-down of growth in SEE in late-2008 and 2009, but that the figures would remain in positive territory in all cases.

The extent to which economists underestimated the severity of the crisis can be shown by taking two examples: the first two columns of Table 1 compare the forecasts for GDP growth in 2009 from the October 2008 IMF World Economic Outlook (WEO) with those from the October 2009 WEO. The difference is staggering; a minimum of 7.5 percentage points (FYR Macedonia, where 5 per cent growth in 2009 was projected a year ago, compared with the current projection of minus 2.5 per cent), and more than 13 percentage points in the case of Romania (4.8 per cent growth forecast a year ago versus an 8.5 per cent drop projected in October this year). But it would be unfair to single out IMF (International Monetary Fund) economists who were no worse than most of those from other international organisations or private institutions. Table 1 also shows that the EBRD's forecasts for 2009 published in November 2008 in the *Transition Report 2008* differ from the forecasts released in October 2009 by a similar amount. It has been a humbling time for economists, as their inability to predict the future – long the subject of jokes – has been even more starkly exposed.

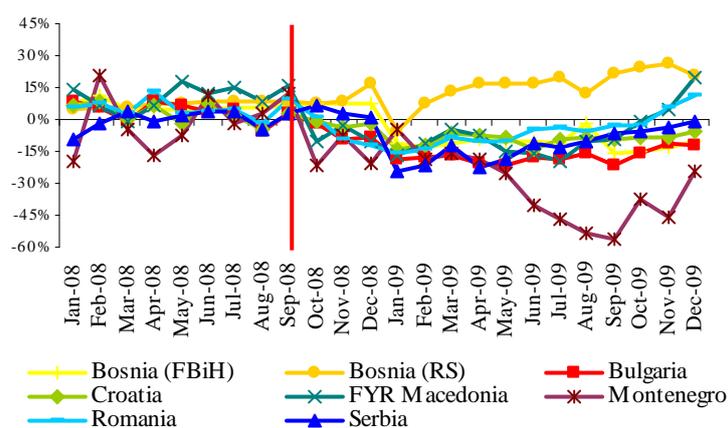
**Table 1. GDP forecast 2009 - IMF World Economic Outlook/  
EBRD Transition Report October 2008 vs. October 2009**

	IMF		EBRD	
	Oct 08	Oct 09	Oct-08	Oct-09
Albania	6.3	0.7	5	3
Bosnia and Herzegovina	5.0	-3	4.5	-3.1
Bulgaria	4.2	-6.5	3.8	-6
Croatia	3.7	-5.2	2	-5.4
FYR Macedonia	5	-2.5	4.7	-1.6
Montenegro	5	-4	5	-4.1
Romania	4.8	-8.5	3	-8
Serbia	6	-4	3	-4

Source: IMF, EBRD.

High-frequency, monthly data on industrial production give a rough idea of when the crisis really began to hit the region. Chart 1 shows how dramatic the change was around September and October 2008. By October, all countries were showing negative year-on-year growth in industrial output except Bosnia and Herzegovina, where the picture is distorted by the re-opening of a major oil refinery in November 2009.<sup>1</sup> Once they turned negative, they stayed that way. There are some recent signs of bottoming-out in most countries, even in Montenegro where the data remain deeply negative, reflecting the continued difficulties of the country's main company, the aluminium conglomerate KAP, but there have been some signs of improvement. These data are notoriously volatile and do not include most economic activity in the region, which is dominated by services, but they do provide the first glimmer of hope that the recession could be coming to an end.

**Chart 1: Industrial production, year-on-year change in per cent**



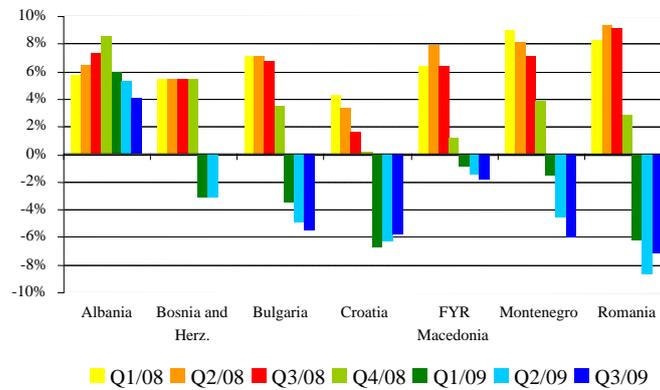
Source: National Central Banks.

The extent of the downturn in 2009 can also be brought out by considering the path of quarterly output (see Chart 2). Most countries still had positive growth in Q4 2008,

<sup>1</sup> Monthly data on industrial production are not available in Albania.

but the full extent of the downturn was already apparent in Q1 2009 (at least for those countries that publish quarterly data).<sup>2</sup>

**Chart 2: Quarterly output**



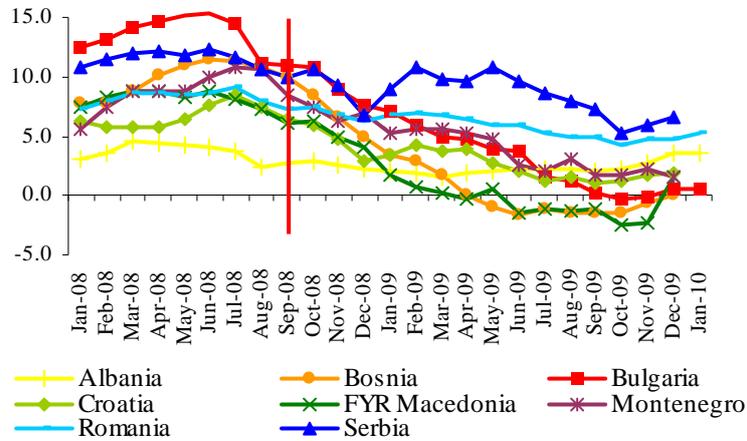
Source: National Central Banks and EBRD estimates.

The drop in economic activity has had a significant impact on other macroeconomic variables, such as inflation, government deficits, and current account deficits. It is also expected to have a serious negative effect on unemployment and poverty in the forthcoming months, raising the possibility of social unrest. It is perhaps paradoxical, however, that the crisis may have had a welcome dampening effect – in a rather brutal way admittedly – on some of the imbalances that had arisen during the boom years.

As an example, consider the course of inflation over the past 18 months. Chart 3 shows that inflation was threatening to become a serious problem again in mid-2008, with double-digit levels at that time in Bulgaria, Serbia, Bosnia and Herzegovina and Montenegro. This now seems like a distant memory. The fall in domestic demand, combined with the steep drop in the price of oil and other natural resources in the second half of 2008, has contributed in several cases to some of the lowest rates of inflation ever seen in this region. The latest rates (December 2009) even point to a deflation in Bosnia and Herzegovina. Bulgaria has moved from having the highest rate in the region in the first half of 2008 to now having one of the lowest. In the case of Romania and Serbia – two countries that have had difficulty in keeping inflation under control – lower inflation has allowed significant cuts in policy rates (see below).

<sup>2</sup> Only “rough and ready” estimates are available for several countries, including Bosnia and Herzegovina and Montenegro.

**Chart 3: Inflation rates**

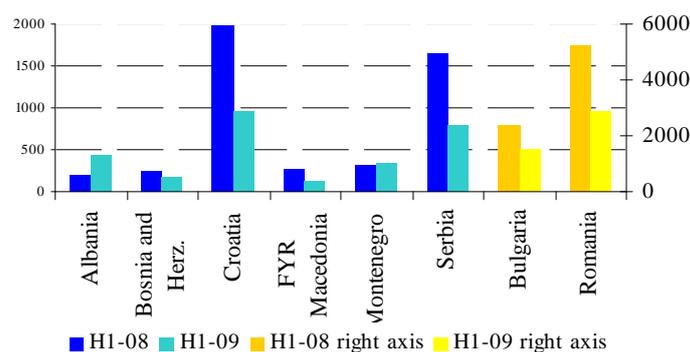


Source: National Central Banks.

In a similar vein, current account deficits have come down markedly during the crisis, as a result of a steep drop in imports that has more than counterbalanced the fall in exports. As a percentage of GDP, the deficit for 2009 is estimated to have come down by more than 10 percentage points in Bulgaria and Montenegro, and by significant amounts in Romania and Serbia. It would be misleading, as many commentators do, to refer to a fall in the current account deficit as an “improvement”; the fact that the recession has meant that firms and people are unable to afford imports to the same extent as before is hardly a cause for celebration. However, to the extent that the previous high deficits were unsustainable, it does represent a move towards a growth model that is less heavily dependent on capital inflows.

Even at lower levels, however, current account deficits have to be financed on the capital side; otherwise the effect will be seen through a loss in foreign reserves. The region has relied on, and benefited greatly from, FDI which has entered into the region in increasing amounts, culminating in a record US\$ 32.5 billion in 2008. But the past year has seen a steep drop, on average close to 50 per cent for the first half of the year (see Chart 4 for the comparison of H1 2008 and H1 2009). The extent of the falls varies by country; Albania and Montenegro have actually seen a rise thanks to some important privatisation deals (an oil refinery in Albania and the power sector in Montenegro), but these are outliers in the bigger picture.

**Chart 4: FDI in millions of euros**



Source: National Central Banks.

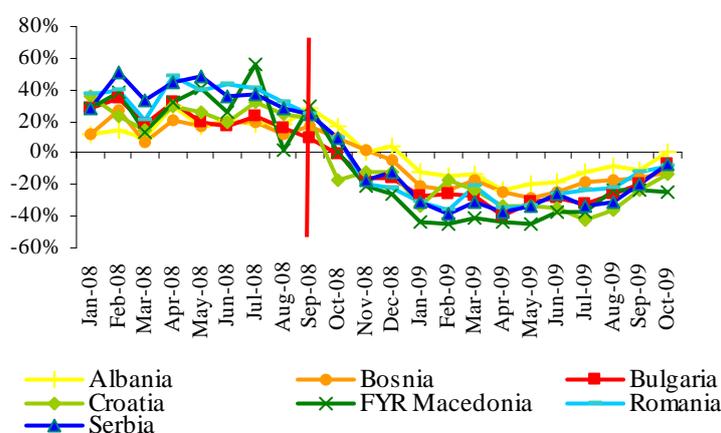
### *Channels of contagion*

The past year has brought out clearly the extent to which SEE is now part of the global economy. While this integration process has brought enormous benefits to the region in the past decade, the downside is that crises that originate elsewhere will affect the region, no matter what actions are taken to mitigate these effects. In the case of SEE, the fall in output has numerous causes. Three explanations stand out as particularly important. First, external demand from the main export markets has dropped sharply, especially for some key commodities that are now produced in the region. Second, access to finance became much more difficult or expensive, which is a serious impediment to the operation of businesses in the region. And third, the volume of remittances has fallen slightly, which in turn is depressing domestic demand as well as hindering the development of small businesses. Each of these will be considered in turn.

Monthly exports are volatile series in SEE, as Chart 5 shows.<sup>3</sup> In the first half of 2008, most countries had exports growing at around 30-40 per cent year-on-year. After September 2008, demand from abroad dried up and exports collapsed, to a level where year-on-year growth was close to, or even worse than, *minus* 40 per cent by early 2009. As with the other high-frequency series cited earlier, there are now signs of stabilisation, with the possible exception of Croatia (though this may be a base effect, given exceptionally rapid growth a year earlier).

<sup>3</sup> Monthly data on exports from Montenegro are not available.

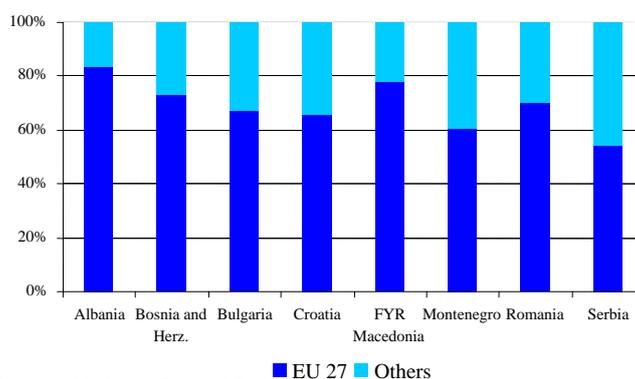
**Chart 5: Exports, year-on-year change in per cent**



Source: IMF, National Bank of Serbia.

In order to get a better understanding of why exports have dropped, it is important to know *what* countries are exporting, and *where* the exports are going to. In recent years, many countries of the region have developed a specialisation in certain key industries. The steel sector is particularly important in Bosnia and Herzegovina, FYR Macedonia, Romania and Serbia. Aluminium is the main export earner in Bosnia and Herzegovina and Montenegro. Romania also has a strong car industry through the Dacia plant (now owned by Renault). Tourism is an important part of the Bulgarian, Croatian and Montenegrin economies. All of these industries have been particularly hit by the global recession, and this is a major factor behind the decline in output in the region. Exposure to the EU-27 has offered little protection; exports have tended to perform badly whether or not a country exports mainly to the European Union (such as FYR Macedonia, where 78 per cent of exports are EU-bound) or Serbia, where just 54 per cent of exports go to EU countries (see Chart 6).

**Chart 6: Share of exports to the European Union in 2008**



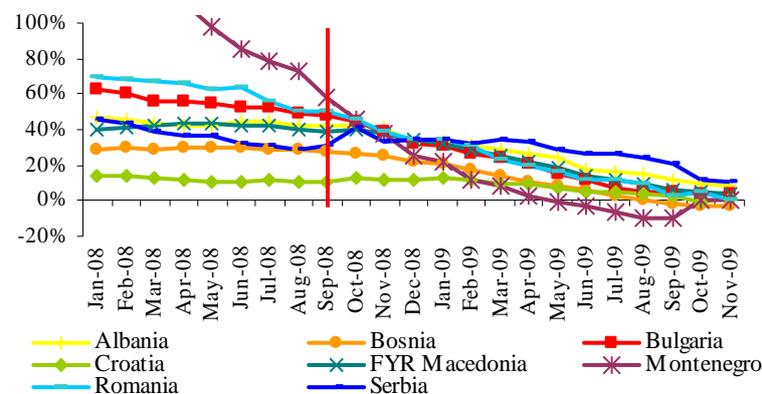
Source: National Central Banks.

Banks and other financial institutions have been major drivers of economic growth in the past decade, but also of rising vulnerabilities. Virtually all countries in the region have had four or more years in a row of a credit boom, defined as annual growth in total credit to the economy by more than two percentage points of GDP (for evidence on this, see the EBRD *Transition Report 2009*, Chapter 3). The most extreme example

is Montenegro, where credit growth at one point was close to 200 per cent (year-on-year). The effects of this growth could be seen in various ways. Many small and medium-sized businesses thrived as they accessed loans at reasonable rates, perhaps for the first time in their existence. Households increasingly enjoyed the new capability of buying (mostly imported) consumer items, as well as taking on mortgages to purchase property. A property boom became noticeable in some of the main cities of the region – Bucharest, Belgrade and Sofia – as well as in tourist-oriented coastal areas in Bulgaria, Croatia and Montenegro.

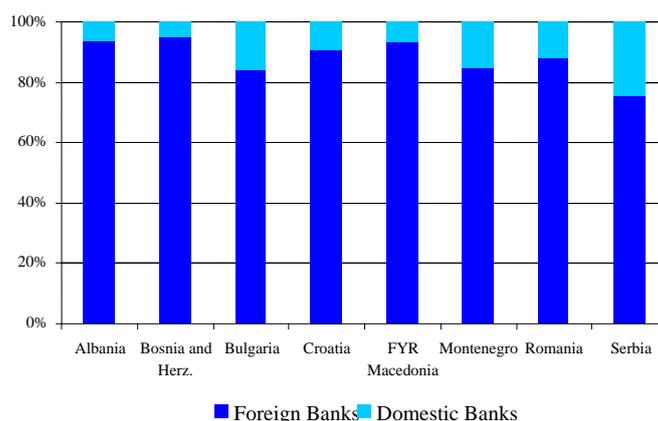
The crisis has contributed to a dramatic slow-down in this growth. In most countries, year-on-year credit growth was still positive (as of November 2009) but in low single-digit levels (see Chart 7). Conversely, credit growth in Bosnia and Herzegovina, Croatia and Montenegro has already turned negative towards the end of the year. The most important reason why credit was not shut off completely must lie in the fact that foreign banks dominate in the region and, as recent research has shown, a high presence of foreign banks has helped to mitigate capital outflows (see the EBRD’s *Transition Report 2009*). Chart 8 shows the percentage share of foreign bank capital in the total in each country. The figures range from 75 per cent in Serbia to 95 per cent in Bosnia and Herzegovina. In other words, foreign banks largely control banking sectors in the region, with all the attendant benefits and risks that this dominance entails. Keeping the banks on board in the crisis has been one of the region’s biggest concerns, and is a topic examined below.

**Chart 7: Credit growth, year-on year change in per cent**



Source: CEIC.

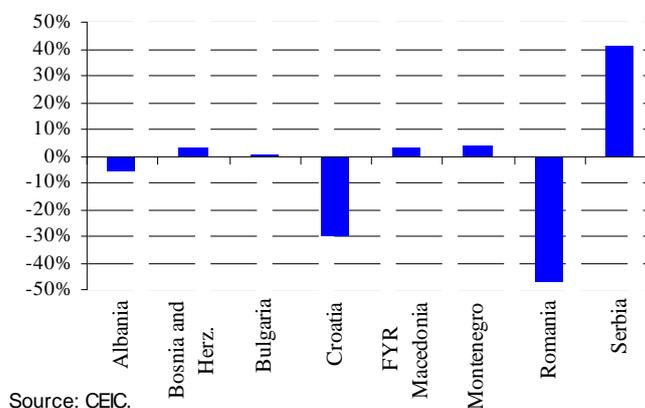
**Chart 8: Share of foreign banks in 2008**



Source: CEIC.

Lastly, the crisis has affected remittances, which have proved a vital source of foreign exchange inflows over the years for most of the region, and indeed a lifeline for many families and small businesses. Chart 9 below reports the latest year-on-year percentage change (Q2 2008 versus Q2 2009) in remittances, based on data from the CEIC database. Several countries show a significant decline, in particular Romania and Croatia. However, the data also indicate that remittances seem to have stabilised in Bosnia and Herzegovina, FYR Macedonia, Montenegro and increased significantly in Serbia, due to an unexpectedly large inflow in the second quarter 2009. In Bulgaria, workers' remittances have also slightly increased by 0.5 per cent.

**Chart 9: Remittances, year-on-year change (Q2 09 vs. Q2 08) in per cent**



Source: CEIC.

### **3. HOW DID THE REGION REACT?**

The macroeconomic figures show how bad the situation has become, but it is important to mention some things that could have happened, and might even (based on the experience of previous crises) have been expected to happen, but did not. First, there has been no failure of a major bank, and no uncontrolled devaluation of pegged (or near-pegged) currencies. Among the floating currencies, the Romanian RON and the Serbian dinar both depreciated fairly sharply in late-2008 and early-2009, but then stabilised (although the dinar has come under seasonal pressure again in early-2010). Second, there has been no breakdown of social order and no dramatic rise in unemployment, although the latter is rising throughout the region and will continue to do so even as economies return to growth. And third, there has been no major backtracking in reform. This section and the following one examine some of the reasons for these small but important crumbs of comfort.

Once the full extent of the crisis became clear in the region, a sense of urgency and even panic set in among policy-makers, businesses and ordinary individuals. There was enormous pressure on governments to be seen to be “doing something”; to come up with some kind of “crisis response” package. But while the intentions were usually good, the means to carry them through were weak or non-existent. For central banks, the crisis entailed a major reversal in thinking. Having become accustomed to worrying and warning about excessive credit growth and its inflationary impact, suddenly they had to deal with a possibly precipitous drop in credit, perhaps combined with a loss of confidence in the banking system. Meanwhile businesses wondered what to do about falling demand – should they cut back production and lay off workers immediately, or would it be better to retain people and hope that things would improve in the near future? And for the population at large, the crisis came at a time when people were already less than happy with their lot. The economic downturn could have been an excuse for further discontent and even social protest.

#### ***Governments***

Governments throughout the region faced an immediate dilemma: spend less to offset shrinking tax revenues and risk cutting domestic demand even further, or spend more and risk crowding out private investment and possible credit rating downgrades. Traditional Keynesian theory, which has come back into fashion in the United States, the United Kingdom and other large western economies, suggests that governments should spend more in a recession to counteract the fall in private demand. But, unlike in the United States and other large western countries, governments in SEE had no obvious means to finance such a deficit-spending programme. The cost of borrowing either on domestic or international markets, on the scale that would be necessary to have a real effect, would be prohibitive in most cases. During 2009, only Croatia in this region tapped international capital markets to any great extent, doing so in May and October 2009 and raising a total of nearly €2 billion. For others, this was not an option.

As a result, most governments announced various fiscal programmes that appeared to be expansionary but in reality have had little impact on the actual economy. Take the example of Romania, where the government announced in February 2009 a €13 billion stimulus package to help counteract the worst effects of the crisis. The idea was to earmark most of it (more than €10 billion) for infrastructure projects. So far,

the “stimulus” has been more imaginary than real; few projects have got off the ground and the effect on economic growth has been negligible. Other countries have tried tax breaks to stimulate businesses. Serbia launched a package in February 2009 which included investment loans at subsidised rates to businesses, as well as consumer loans for the purchase of Serbian goods. In a similar vein, the FYR Macedonian and Montenegrin governments have tried to reduce the tax burden by selective cuts for businesses and households, while in Bosnia and Herzegovina, a targeted programme for the less well-off involved the exemption of certain essential goods from VAT. All of these measures have brought some relief here and there, but they cannot be said to constitute a coherent anti-crisis approach.

The room for manoeuvre was further limited by the fact that most governments had run fairly expansionary fiscal policies during the boom years, and therefore had little in reserve when the downturn arrived. Collapsing revenues and limited access to new borrowing therefore forced most governments to reduce spending. This is not easy to do, and most have been rather hesitant. In Croatia, where government spending (as a percentage of GDP) is among the highest in the region, the government played a kind of catch-up game last year, revising the 2009 budget three times, with each revision accompanied by further spending cuts and a downward revision of the GDP growth forecast. Those countries that have IMF programmes – Bosnia and Herzegovina, Romania and Serbia – have found the Fund surprisingly lenient (compared with its traditional approach) in accepting relatively substantial government deficits last year, and (in the case of Romania and Serbia) in agreeing to an upward revision of the deficit target for 2009 once the full extent of the economic downturn became clear. But the big fiscal challenges will come this year and beyond. Continued IMF support will depend on serious efforts to place public spending on a sustainable, lower path. In countries that have frequent elections and potentially unstable coalition governments, this will not be easy.

One of the most important steps taken by many governments in the region has been to increase the level of deposit insurance and shore up confidence in the banking system. In the last quarter of 2008, the need for this became absolutely urgent. Several countries were facing a serious loss of confidence in their banking systems, especially Bosnia and Herzegovina and Serbia. In both cases, people have relatively fresh memories of hyper-inflation and of effective confiscation of foreign deposits. It is estimated that there was a foreign currency deposit outflow of €1 billion (15 per cent of the October level of deposits) in Q4 2008 in Serbia and around €400 million in Bosnia and Herzegovina. There were also fears about significant outflows in Croatia and Montenegro. In each case, decisive action was taken – Croatia and Serbia raised the limit to approximately €50,000 in October 2008, while in Bosnia and Herzegovina, the limit was raised more modestly to around €10,000 in October 2008.<sup>4</sup> Montenegro went furthest of all, by issuing a 100 per cent guarantee on all deposits, again in October 2008.

Initially there was scepticism and even cynicism about the credibility of such deposit insurance. Indeed, no government would have been able to fully recompense depositors in the event of a serious bank run and subsequent collapse of major banks. But this criticism misses the point that these steps did help engender a new sense of

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<sup>4</sup> An EBRD loan to the deposit insurance agency in Bosnia and Herzegovina, signed in January 2010, will enable the level of coverage to be raised to around €25,000.

confidence among the population at large, as witnessed by the steady return of deposits since the dark days of Q4 2008. In Serbia, the level of deposits had, by the end of 2009, returned to where it was before panic set in, vindicating the actions both of the government and of the central bank.

To sum up, governments were right to signal support to their financial systems in late 2008, but had insufficient fiscal means to arrest the crisis and make things easier for firms and households. More encouraging is the fact that they have, almost without exception, avoided the temptation to roll back the structural reforms that have been put in place over the previous two decades. There has been a significant slow-down in reforms as governments have generally been too distracted with crisis management. Some important potential privatisations – shipbuilding in Croatia, telecommunications in Bosnia and Herzegovina, mining in Serbia – have failed or been delayed, mainly because it is hard or even impossible to find investors in the present climate. At the same time, there seems to be no appetite for a major reversal of the reform programme of the past two decades, and for that, governments deserve praise.

### ***Central banks***

In general, central banks throughout the region have reacted sensibly and effectively to the crisis, albeit in different ways. This reflects the fact that, over the past decade, all central banks in the region have built up a reputation for independence, competence and professionalism, qualities that are often lacking in other public sector institutions. Of course they cannot be exempt from criticism in the boom years. In retrospect, some of them would have been well-advised to follow the example of the Croatian central bank in imposing strict upper limits on credit expansion (although even in Croatia this came somewhat late in the credit boom period). Others were arguably too relaxed about the extent of lending in foreign currencies, particularly in “exotic” currencies like the Swiss franc or the Japanese yen, where seemingly attractive low rates of interest may have concealed the high risks (through depreciation of the local currency) facing the borrower. But once the crisis entered into full swing, the central banks generally played an important calming and mitigating role.

The tools available to central banks in SEE are limited. Most can set a key policy rate (usually some kind of short-term repo rate), which in turn affects interest rates elsewhere in the economy; they can vary the reserve requirement rate (with differential rates depending on the denomination and maturity of the deposit); and they can use foreign reserves to intervene on the foreign exchange market to defend the currency. Central banks have used a combination of these policies at some stage in the past 12 months.

The biggest reduction in the policy rate has been in Serbia, where the two-week repo rate has been lowered by a cumulative 825 basis points since January 2009, to a rate of 9.5 per cent as of early-February 2010. Inflationary pressures tend to be higher in Serbia than in other countries of the region, and memories of high or even hyperinflation are still strong. Therefore, the central bank had aggressively raised interest rates during the boom times in an effort to keep a lid on inflation and credit growth. The recession has allowed this policy to be reversed, while still keeping inflation on a downward path. A similar pattern emerged in Romania, although the extent of the reduction was smaller: 325 basis points (down to 7 per cent as of early-February

2010) since the start of 2009. Significant policy rate cuts have also occurred in Albania and Bulgaria.

In Croatia and FYR Macedonia, in contrast, the central banks have been reluctant so far to cut policy rates as a crisis response, reflecting a different approach to exchange rate policy. In fact, the move has so far been in the other direction: The Croatia central bank raised the key policy rate from 4.5 per cent to 9.0 per cent in November 2008 as part of its efforts to defend the (relatively) hard currency peg. In FYR Macedonia, which has an even harder peg, the policy rate was raised in March 2009 from 7 to 9 per cent (subsequently cut to 8 per cent in January 2010). This tool is not available in Bosnia and Herzegovina, which has a strict currency board, or in Montenegro which has unilaterally adopted the euro.

When it comes to reserve requirements, there has been far more uniformity in response. All countries (except Albania and FYR Macedonia) have lowered the mandatory reserve requirement at some point in the past year, in an effort to ease liquidity and encourage banks to keep lending, or at least to cut lending by less. There is still wide heterogeneity in the region in reserve requirements. In Bulgaria for example, minimum reserve requirements on funds attracted by banks from abroad were reduced from 10 to 5 per cent in January 2009, while those on government deposits were eliminated. In neighbouring Romania, in contrast, reserve requirements on foreign currency-denominated liabilities have come down progressively from an initial rate of 40 per cent to 25 per cent as of early-February 2010 (those on local currency liabilities are 15 per cent). The overall direction is therefore clear: central banks at present are primarily concerned about getting lending to the real economy, and they recognise that excessive reserve requirements can hinder this process.

As already mentioned, there have been large differences in exchange rate policy within the region, ranging from managed floats (Albania, Romania and Serbia – with Romania and Serbia allowing significant depreciation of their currencies in 2008 and early 2009) to pegs (or near-pegs) in the case of Croatia and FYR Macedonia, currency boards in Bosnia and Herzegovina and Bulgaria, and unilateral euroisation in the case of Montenegro. But despite the differences, one common thread has run through exchange rate policies since the early 1990s. All countries recognise the value of exchange rate stability and are prepared in most circumstances to intervene in the foreign exchange market to prevent excessive fluctuations (the obvious exception being Montenegro where there is no local currency to defend). Even in the two countries that allowed large depreciations, there was significant central bank intervention to prevent an even bigger drop. In both countries the exchange rate has stabilised since then, indicating that market confidence has returned.

### ***Firms and workers***

At the firm level, the response to the crisis has been broadly as expected. Many enterprises have had to cut back on production and lay off workers. Others have resorted to wage cuts or freezes in an effort to contain costs. The big metals producers in the region – US Steel in Serbia, ArcelorMittal in Bosnia and Herzegovina, FYR Macedonia and Romania, KAP in Montenegro and Silmak ferro-alloy furnace in FYR Macedonia for example – all had to cut production drastically for a period, and some firms resorted to introducing a reduced working week, as a way of retaining staff and minimising job losses, presumably in the hope of a global upturn.

The reaction of ordinary individuals and workers has been perhaps one of the most surprising and encouraging features of the crisis. At the start of the crisis, there were fears that an economic downturn would trigger severe social unrest. These fears were fuelled by the fact that people in this region seem to be quite discontented with life even in the boom period. The EBRD/World Bank Life in Transition Survey (LiTS) carried out in 2006 showed a marked difference in average life satisfaction between SEE countries and other transition regions, with SEE countries typically near the bottom of the entire transition region. The Gallup 2009 Balkan Monitor provides further support for this rather bleak view of the region's inhabitants (at least those in the Western Balkans) as incorrigible pessimists. But so far this has had little effect on the political life of these countries.

It is true that there have been some significant protests, but what is perhaps surprising is the scarcity of these events. The biggest worker protest so far was in Romania, which had a major one-day strike in October 2009, when around 800,000 public sector employees protested about government measures to freeze wages and reduce pensions. Other significant protests occurred in Bulgaria in January 2009, involving street rallies; in Serbia in April 2009 when several thousand members of the Sloga independent unions protested in Belgrade against the government's crisis response (or the inadequacy thereof); and more recently in Bosnia and Herzegovina. Since then, unions in Serbia, Croatia and Romania have threatened further strikes, but by early-2010 these had not yet come to pass.

Why has this been the case? One hypothesis is that people have understood that the recession in their country is driven primarily by global forces, the likes of which the world has not seen since the 1930s. That means that they are less likely to blame their misfortune on the incompetence of local politicians. Indeed, where elections have been held this year, incumbent governments have often done quite well, notably in Albania and Montenegro where they were successful in gaining re-election. Similarly, the ruling party in the March 2009 presidential elections in FYR Macedonia was also successful, reflecting the popularity of the dominant party in government. In Romania, the coalition government collapsed in October 2009 as a result of internal divisions, but the eventual outcome has been the return of substantially the same government (and the same Prime Minister). In Bulgaria, the government was thrown out by the electorate in the parliamentary elections in July 2009, resulting in a new government that is, if anything, even more committed to macroeconomic stabilisation and reforms.

#### 4. THE ROLE OF THE INTERNATIONAL COMMUNITY

Countries in SEE have needed help from abroad in coping with this crisis. Over the past decade, the region has greatly benefited from, and relied on, a combination of official support – from bilaterals and from international financial institutions (IFIs) – and support from private investors and banks. Once the crisis began to take root, there was a palpable fear that the region might be abandoned to its short-term fate. But the reverse has happened; the international community, and IFIs in particular, have stepped up their support for the region in a major way. Perhaps more surprisingly, under the "Vienna Initiative" – a public-private coordination forum involving all major financial stakeholders (see *EBRD Transition Report 2009*, Box 1.4 and following) – foreign banks have also pledged support to their subsidiaries, and have backed this up in several cases (specifically, those countries that have IMF programmes – Bosnia and Herzegovina, Romania and Serbia in SEE, as well as several other countries in other parts of the transition region) by publicly committing to maintaining the level of exposures at end-2008 levels. This may be the most important reason for the absence of either a currency collapse or a failure of a major bank in the region so far.

Among the IFIs, the most dramatic shift in both direction and speed has occurred in the IMF. For several years, this institution had been winding down its financial operations in SEE. Countries in the region increasingly felt that they no longer needed balance-of-payments support from the IMF, although technical support in selected areas would still be welcome. Moving away from Fund-supported programmes became almost a rite of passage for countries on their way to greater prosperity and EU integration. For its part, the IMF had little choice but to accept this situation. By September 2008, the only country in the region with an IMF-supported programme was Albania, and throughout 2008, IMF offices were closed in several countries, including Bosnia and Herzegovina and Serbia. The IMF office in Bucharest (which covers both Romania and Bulgaria) was also scheduled for closure in early-2009, but this plan was reversed when it became clear that the Romanian authorities were likely to seek a programme.

Since the middle of last year, an extraordinary turnaround has occurred. The first Balkan country to approach the IMF for a programme was Serbia, which secured a precautionary arrangement in January 2009. Very soon, it became clear to both sides that the country would need more than this, and so this arrangement was replaced in May 2009 by a 27-month extended arrangement of around €3 billion. The value of this programme to the Serbian authorities is two-fold. First, it provides assurance to foreign investors that the country has adequate foreign reserves to meet its obligations. That is the usual rationale for IMF loans. But perhaps equally importantly in the Serbian context, it gives the authorities some political cover for taking difficult decisions in sensitive areas such as public sector employment reductions or pension reform. Given the unwieldy multi-party structure of the current government, with many competing and potentially incompatible interests, IMF backing is vital. The programme encountered a minor delay in the second review in autumn 2009 but as of early-2010 it remains on track.

The Serbian agreement was followed in 2009 by new programmes with Romania (in March) and Bosnia and Herzegovina (in July). The Romanian deal was particularly substantial, reflecting the gravity of the economic situation and the needs of the

country. The total value was just under €13 billion, spread over more than two years, and this was tied explicitly to a further €5 billion of support from the European Union. At the same time, the EBRD and World Bank pledged that they would aim to invest around €1 billion each over 2009 and 2010. The result was therefore a headline package of IFI support of €20 billion, enough to reassure most investors, and the effect in terms of improving confidence and lowering risk perceptions was immediate. The situation was complicated temporarily by the collapse of the government coalition in October 2009 and the initial failure of parliament to approve a budget for 2010, but the formation of a new government unlocked the problem and enabled the programme to remain on track. Meanwhile, the programme in Bosnia and Herzegovina, which amounts to €1.2 billion, is at an early stage; an IMF programme review in November reached an agreement on disbursing the next tranche in early 2010, provided certain fiscal steps are taken before then. As of early-February, these steps remain to be taken.

Will other countries in the region go the same way and adopt an IMF programme? So far, there is a reluctance to adopt this path. Memories are still raw in some cases from the difficulties encountered during previous programmes and the perceived intrusiveness of the IMF in decision-making. But the IMF has learned some lessons from the past too. The new programmes in the region, and those in countries such as Hungary and Latvia, are generally less prescriptive and contain fewer conditionalities than previous programmes did. There is also more flexibility in allowing parts of the funding to be used for budgetary, rather than balance of payments, support. While it would be unfair to characterise the new-look IMF as handing out the money with no questions asked, the strings attached to disbursement are much more narrowly defined than before.

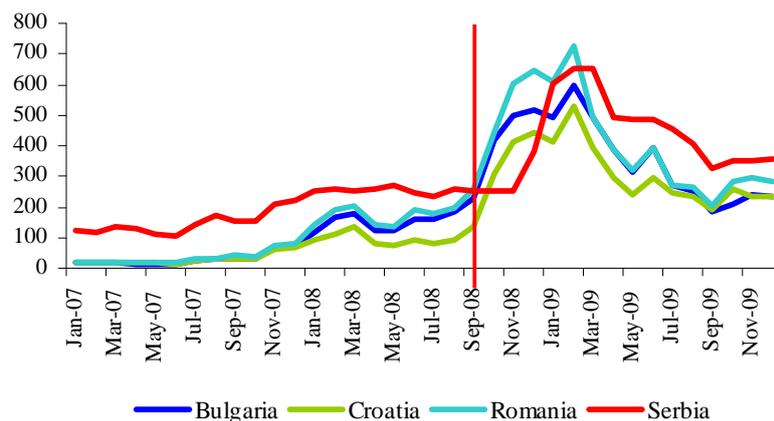
Other institutions active in the region – the EBRD, EIB and the World Bank – are also stepping up their support. All three institutions joined forces in February 2009 to declare strong support for the banking sector across the whole transition region, including south-eastern Europe. The headline figure was €24.5 billion in new funding for banks over the next two years – arguably small in comparison to the potential needs of the sector but an important step nonetheless. But the support is not just confined to the financial sector. All three institutions are active in infrastructure – helping to build and refurbish roads, railways and power systems – and in the corporate sector to ensure that financing for businesses is still available on reasonable terms.

The European Union has also shown some unusual flexibility in helping non-member countries with fiscal support and with broader support for banks and SMEs. In July 2009 the European Union pledged €100 million in budgetary support for Serbia (two tranches of €50 billion, one in autumn 2009 and the other in spring 2010), under the Instrument of Pre-Accession (IPA) programme. This is the first time the IPA has been used for direct assistance to the budget. And in August 2009, the European Union gave €9 million to Bosnia and Herzegovina in support of SMEs, infrastructure, environment and energy, as well as enhanced funding for the deposit insurance agency. This shows that the soft power of the European Union can also be backed up with hard cash when necessary, something that may surprise those who see the European Commission (the executive arm of the European Union) as excessively bureaucratic.

IFI support is not just about pumping in money; it also involves coordination, information-sharing and even a bit of arm-twisting now and again. The crisis has resulted in an innovative initiative whereby international institutions such as the EC, EBRD and IMF have helped to ensure that foreign-owned banks in the region will continue to receive support from their parent banks in Western Europe. The key idea of the “Vienna Initiative”, as it is commonly known, is to ensure voluntary buy-in from these banks, in the context of IMF-supported lending programmes to the country. In some cases, financial institutions receive IFI funds directly as an incentive to on-lend to the enterprise sector. In March 2009, the main foreign banks active in Romania and Serbia committed publicly to maintaining their support for their subsidiaries throughout 2009, recognising that it was very much in their own best interests. A similar pledge was made by the six main foreign-owned banks in Bosnia and Herzegovina in July 2009. Without IFI support, it is unlikely that these banks would have been able to come to such an agreement, and the likelihood of one or more banks jumping ship would have been much higher.

The overall effect of international support can in principle be quantified by computing the amounts pledged and disbursed, but such a calculation would miss an important part of the story, namely, the return of some level of confidence to the region. One way to see this is to look at how credit default swap (CDS) spreads have evolved during the crisis. Data are available for the four larger economies: Bulgaria, Croatia, Romania and Serbia, and are shown in Chart 10. The peak in most cases came around February or March 2009, when the sense of panic about the region’s prospects was at its height. Since then, the path has been steadily downward, to the point where spreads are not that far above their pre-crisis levels. We can expect to see some volatility in the coming months, and maybe upward blips now and then, but nothing like as bad as it could have been. A contributing factor to this was the international community’s response package.

**Chart 10: CDS spreads**



Source: Bloomberg.

## 5. LESSONS LEARNED

As of early-February 2010, the region is in a state of calm, economically speaking. Of course, that is not how those who are going through the crisis might see it. The effects have been devastating for many people, especially those who have lost their jobs or faced cuts to wages or benefits. There is also the fear that we have not seen the worst yet, that unemployment will get much worse, and that banks have hidden or ignored deep balance sheet problems that will inevitably emerge at some point. But notwithstanding these points, it does seem to be the case that most economies have reached some kind of turning point, and that a return to growth, albeit at rather anaemic levels, can be contemplated with some confidence.

What are the main lessons learned from the crisis? It is tempting to say that it is too early to say; that we have to wait and see if there are major second-round effects and, if so, how the region will cope with these. However, it is possible to come to preliminary conclusions about what the crisis has taught us. Five points come to mind.

First, market-oriented reforms have become deeply embedded in the region. It is notable that there has been little or no reversal of previous reforms during the crisis. Almost no-one has suggested that it would be a good idea to re-introduce price or exchange controls, or to renationalise major companies and banks. There have been a few isolated cases of the state stepping back in to alleviate a difficult situation. An important example is the partial re-acquisition by the Montenegrin state of KAP. But this action must be seen in context; KAP is enormously important to the Montenegrin economy and a sudden closure of the company would have devastating knock-on effects. The government's response may therefore be seen as the most appropriate one under the circumstances.

Second, the region will have to get used to a period of lower growth in coming years. It is now clear that the previous model, relying on massive capital inflows to fuel double-digit current account deficits, will not return in the short run, and probably not even in the medium or long term. Banks are bound to be much more cautious in the future, especially when it comes to cross-border lending, and they are also likely to face a tougher international regulatory regime. This means that SEE countries will have to figure out ways to develop local sources of finance and, while there are ways in which this can be achieved, it is likely to take a considerable length of time.

Third, more emphasis is needed on putting mechanisms in place for credible, multi-year planning of fiscal policy. Although fiscal deficits were in most countries quite modest during the boom years, it is now obvious in retrospect that they should have been more conservative. In some countries – Romania being a prime example – implicit long-term commitments were made on public wages, pensions and other benefits that might have been feasible if growth rates of 6-7 per cent continued indefinitely, but are definitely not sustainable in a lower growth scenario. But unwinding these commitments is politically very costly. Ultimately, the introduction of far-sighted fiscal policy requires far-sighted policy-makers and voters.

Fourth, the crisis has demonstrated clearly the benefits of cross-border cooperation, not just among government officials and international organisations but also with the private sector. Cooperation is not just about one side giving the other money, but also about information-sharing and demonstration effects of best practice, leading to more

probing and courageous financial stability analysis. Before the crisis, central bank governors in the region sometimes complained that they had to rely on foreign newspapers and other media to find out what parent banks were up to. The “Vienna Initiative” could also be used as a model for other areas, one example being the development of local currency lending.

Fifth, this paper pointed out how the crisis has demonstrated the inadequacies of the economics profession when it comes to predicting the future. In defence, one can say that this crisis was a once-in-a-lifetime global event, the effects of which were impossible to predict. It is hoped that an understanding of the channels through which events in one part of the world were transmitted elsewhere will help economists build more accurate and meaningful models. This is not a frivolous academic point; policy-makers need to make judgements about the future when deciding current policy. If the crisis leads to future forecasts that are less wildly inaccurate than those in the recent past, it will be a small but important step forward.