

SEE Spotlight

News, research and analysis on south-eastern Europe

Issue No. 3, December 2010

EDITORIAL

Economic conditions remain more difficult in SEE than elsewhere in the EBRD's countries of operations. The EBRD's latest forecasts, released in October (see page 3 below), show that, on a weighted average basis, economic growth this year will be negative. While all countries are now expected to grow in 2011, the pace of growth will be well below the levels achieved in the pre-crisis years.

This edition of *SEE Spotlight*, the third in the series, shows that all of the main forms of foreign inflows – FDI, remittances and cross-border bank lending – have dropped significantly during the crisis and remain subdued. While this may be a temporary phenomenon, the SEE region cannot expect, and should not want, to return to the pre-crisis model of rapid capital inflows and excessive credit growth.

These findings lead to the main message of the recently published EBRD *Transition Report* (available at:

<http://www.ebrd.com/pages/research/publications/flagships/transition.shtml>) – namely, that transition countries, including those in SEE, need a new growth agenda, based on the promotion of local capital markets, the removal of obstacles to exports (leading in turn to increased innovation and growth) and the tackling of the most serious impediments in the business environment.

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European Bank
for Reconstruction and Development

RECENT RESEARCH

W. Bartlett: *The Social Impact of the Economic Crisis in the Western Balkans with a focus on the Republic of Macedonia*, European Institute, London School of Economics, London (July 2010).

<http://www2.lse.ac.uk/europeanInstitute/research/LSEE/PDF%20Files/Latest%20Research/2010item10WJB.pdf>.

The paper assesses the effects of the economic crisis in the Western Balkans, in particular FYR Macedonia, through a household survey conducted in summer 2009. It concludes that the social impact in terms of unemployment and pension provision has been much worse than macroeconomic data indicate.

M. Holzner: *Inequality, Growth and Public Spending in Central, East and Southeast Europe*, wiiw Working Papers 71 (October 2010), Vienna Institute for International Economic Studies, Vienna.

<http://publications.wiiw.ac.at/?action=publ&id=recent>.

The analysis argues that low interest rates foster both equity and economic development, and that the European Integration Process is key to social equality and economic prosperity.

H. Grabbe, G. Knaus and D. Korski: *Beyond Wait and See: the Way Forward for EU Balkan Policy*, European Council for Foreign Relations, London (May 2010). <http://ecfr.eu/page/-/documents/balkan-policy-brief.pdf>.

The paper discusses the EU approach towards integration of the Western Balkan countries. The authors recommend reinforcing the EU's accession conditionality to shape domestic policy and to employ existing tools more effectively in order to counteract increasing doubts in the region about their countries' EU future.

A. Chailloux, F. Ohnsorge and D. Vavra: *Euroisation in Serbia*, Working Paper No. 120, European Bank for Reconstruction and Development, London (October 2010).

<http://www.ebrd.com/downloads/research/economics/workingpapers/wp120.pdf>.

The paper documents the reasons underlying the high degree of euroisation in the Serbian economy. It argues that a combination of disinflationary policies, combined with regulatory measures, could aid the process of de-euroisation.

Foundation for the Advancement of Economics, Belgrade *Quarterly Monitor of Economic Trends and Policies in Serbia*, Issue 21, April – June 2010.

http://www.fren.org.rs/index.php?option=com_content&view=category&layout=blog&id=2&Itemid=5&lang=en.

This quarterly report provides a comprehensive analysis of recent macroeconomic developments in Serbia. It additionally offers an analysis of the effects of the fiscal stimuli, trends in the Serbian labour market and the recent exchange rate adjustment.

RECENT ECONOMIC DEVELOPMENTS

Industrial production is stagnating. In spite of good performance throughout most of 2010, industrial production seems to be slowing, with many countries recording negative year-on-year figures in October. An exception to this trend is Montenegro, where IP surged significantly in the past months— mostly attributed to the re-opening of the country's sole thermo power plant that temporarily suspended production in May last year. However, it has weakened again in October to 37.1 per cent and does not yet fully compensate for the sharp drop in 2009.

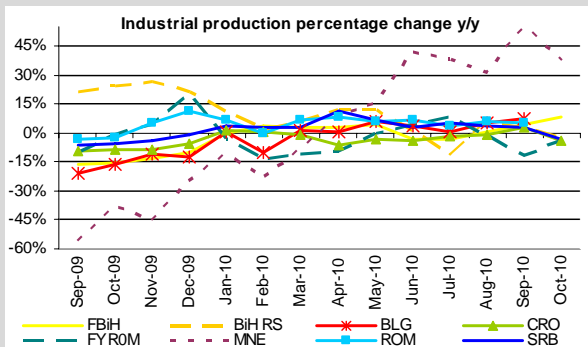
Export activity accelerates. Exports are rebounding strongly, continuing the trend of increased trading activity since the beginning of the year. Exports are anticipated to recover further until the end of the year, supporting the tentative economic recovery taking place in most SEE countries. In addition, domestic demand seems to be resuming slowly, with imports gradually increasing throughout the region.

Inflationary pressures increase. In light of increasing food prices, consumer price indices (CPI) have risen throughout the region, though the level of inflation is anticipated to remain moderate in most countries at below 4 per cent. In Romania, inflation has picked up substantially in recent months, owing mainly to the government's decision to increase VAT by 5 percentage points (from 19 to 24 per cent) as of July 1st 2010. In Serbia, inflationary pressures have also increased significantly, with the rate reaching 8.9 per cent in October; inflation is now expected to breach the upper ceiling of the central bank's inflation target of 6 ± 2 per cent for end-2010.

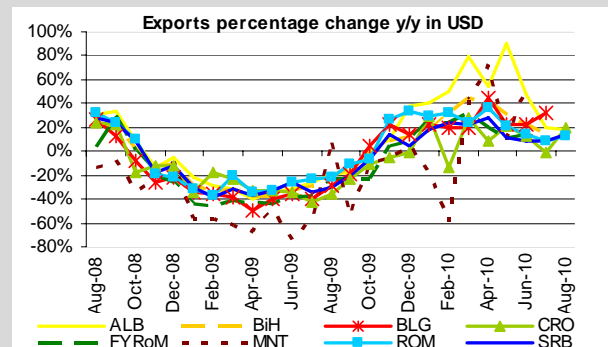
Risk perceptions almost back to pre-crisis levels. Credit default swap (CDS) spreads for SEE's most advanced economies have fallen substantially since early 2009. After a temporary increase in spring 2010, mostly generated by fears about contagion effects from the Greek debt crisis into SEE, risks have been reduced again since September and returned to below 300 basis points. A small but insignificant rise in spreads has been observed in late November, possible as a result of the renewed Eurozone debt crisis.

SELECTED MACROECONOMIC INDICATORS

Real Economy

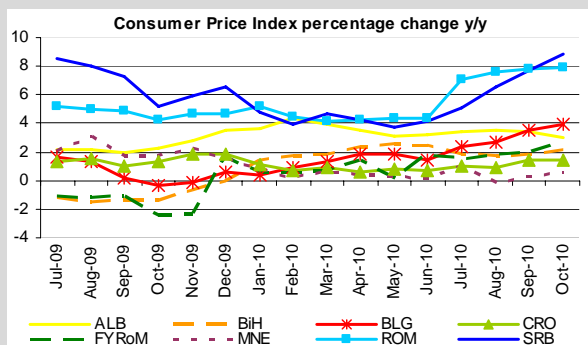


Source: National Statistical Offices.

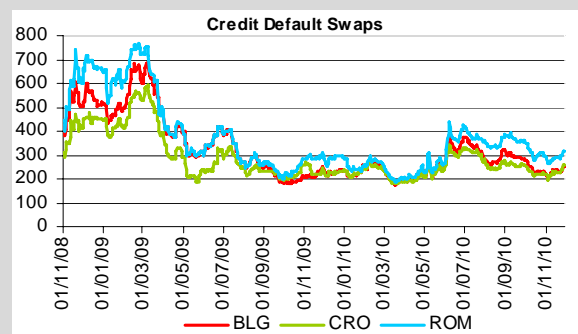


Source: CEIC, National Bank of Serbia.

Inflation and CDS spreads



Source: National Central Banks.



Source: Bloomberg.

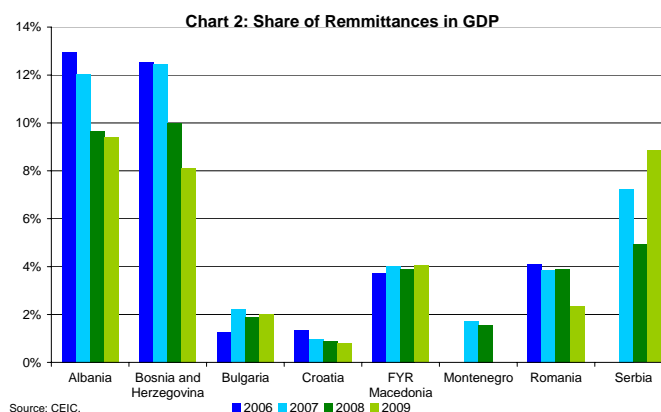
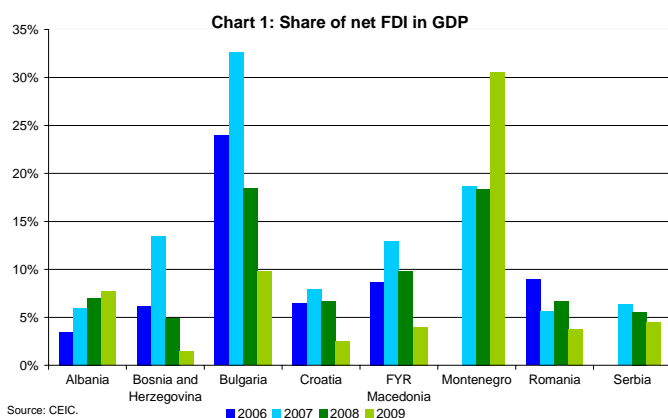
ANALYSIS: Foreign Currency flows into south-eastern Europe – recent trends

South-eastern Europe is still struggling to emerge from the global economic downturn and continues to lag behind the rest of the transition region. Although growth projections in five SEE economies have been revised upwards in the EBRD's most recent growth forecast (October compared to July 2010) – most prominently Albania and Bulgaria – there is no evidence yet of a substantive recovery in the region. Two of the region's largest economies – Croatia and Romania – as well as Montenegro, are even projected to record negative growth rates in 2010. On a weighted average basis, real GDP is forecasted to decline by -0.6 per cent in SEE, compared to a forecast of 4.2 per cent growth for the whole transition region. The outlook for 2011 is somewhat better, with positive growth forecast in all countries, but the rates of growth currently foreseen are rather anaemic compared to the pre-crisis period.

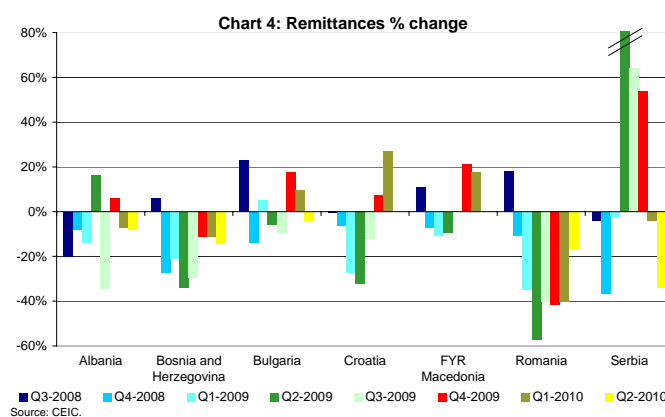
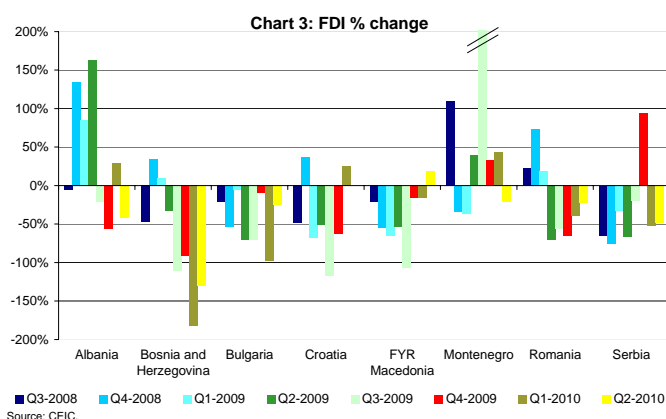
Table 1: Growth in real GDP in 2010 and 2011

(EBRD forecasts as of October 22nd 2010)	GDP Growth (year on year per cent change)	
	2010	2011
Albania	3.0	2.2
Bosnia and Herzegovina	0.8	2.2
Bulgaria	0.4	2.4
Croatia	-1.5	1.9
FYR Macedonia	0.8	2.3
Montenegro	-0.6	2.5
Romania	-2.0	0.9
Serbia	1.6	2.9

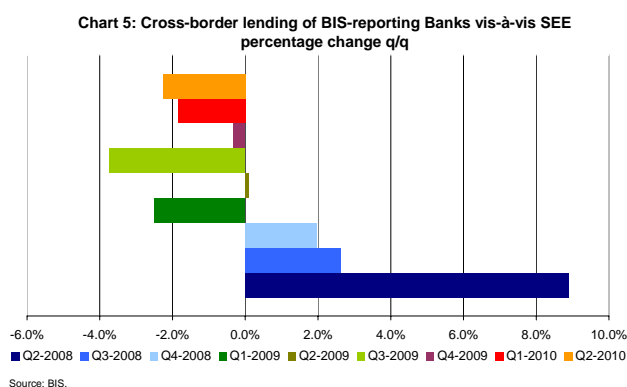
The boom years of the past decade were fuelled to a large extent by a considerable amount of foreign direct investment (FDI), remittances and cross-border commercial bank lending, which accelerated significantly in the immediate pre-crisis period. Chart 1 shows how important net FDI inflows were (relative to the size of the economy) in the period 2006-08, and how much it declined in most countries in 2009 (with the exception of Montenegro). Chart 2 highlights the importance of remittances for some Western Balkan countries. Pre-crisis, remittances were a particularly important source of income in Albania, Bosnia and Herzegovina, and Serbia (as well as in Kosovo) – all with traditionally strong Diasporas abroad – amounting to more than 10 per cent of GDP in several cases.



During the crisis, these inflows have declined substantially and show little sign of recovery in the first half of 2010. Charts 3 and 4 show for each quarter (mid-2008 to mid-2010) the year-on-year inflows of FDI and remittances respectively. With some minor exceptions, FDI has continued to decline in the first half of 2010, and as investor confidence remains gloomy, FDI is unlikely to return to pre-crisis levels in the near future. Available data on remittances indicate some sign of improvement in a few countries, but with unemployment in many Western European countries - notably in Greece - still on the rise, these are also anticipated to remain subdued for some time.



Finally, data provided by the Bank for International Settlements (BIS) on quarterly changes in cross-border assets (exchange rate-adjusted) of BIS-reporting banks show that commercial banks continue to reduce their assets in the region (see Chart 5). Although there was a temporary improvement at the end of 2009, it appears that the Greek debt crisis, which emerged in early 2010 and raised concerns about negative contagion effects into its neighbouring region, has led to a renewed restriction in cross-border lending, and BIS-reporting banks reduced their assets by 2.3 per cent q/q in the second quarter.



In conclusion, the drop in all three main components of foreign exchange inflows to the region is likely to depress growth prospects in the short-term. That is why there is increasing attention at present in policy debates on a new "growth agenda", a debate to which the EBRD's *Transition Report 2010* makes a major contribution. This agenda should be primarily based on an increase in export activity and an improved business environment. It is encouraging therefore that exports are bouncing back strongly, as shown in the chart on page 2 of this *Spotlight*. It is less encouraging that SEE countries tend to perform fairly poorly in the World Bank's *Doing Business* scores; the most recent edition, published several weeks ago, showed that only Croatia and Serbia improved their ranking on ease of doing business relative to the previous round, and both from a low base. In short, there is considerable room for improvement in all of these countries.