

SEE Spotlight

News, research and analysis on south-eastern Europe

Issue No. 2, July 2010

EDITORIAL

This issue of *SEE Spotlight*, the second in the series, comes at a difficult time for the region. The latest economic data suggest that the crisis in south-eastern Europe is still in full swing. The EBRD's latest growth forecasts, released on 22 July, show a significant deterioration for this year relative to just two months ago, especially in Romania but also in Croatia and FYR Macedonia (see *Analysis* below). We focus in this newsletter on trade developments. The recent upturn in exports across the region is mildly encouraging news, but the continued stagnation of imports highlights the depressed state of domestic demand in south-eastern Europe.

Where does the region go from here? It is important not to be overly-pessimistic about the region's prospects. Provided one takes a medium-term, then there is still plenty of potential for countries in SEE to catch up on richer neighbours. This is a point that Chris Cvičić and I try to emphasise in our recent book: *In Search of the Balkan Recovery: the Political and Economic Reemergence of South-Eastern Europe* (published by Hurst & Co., London). Although the region has been hard hit by the crisis, the achievements of the previous decade are largely intact and still provide, in our view, a good foundation for a return to the growth path in the coming years.

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European Bank
for Reconstruction and Development

RECENT RESEARCH

Bank of Greece and Oxford University: *Challenges and prospects of SEE Economies in the wake of the financial crisis.*

This is a report on a conference at the Bank of Greece in October 2009. Participants, including central bank governors, IFI representatives and academics, discussed the experience during the global crisis in South-Eastern Europe and neighbouring economies and considered what lessons policy-makers should draw for the future.

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

E. Markova: Effects of migration on sending countries: lessons from Bulgaria, *LSE Hellenic Observatory Papers on Greece and Southeast Europe, May 2010.*

The author argues that emigration from Bulgaria has had substantial economic and demographic consequences for the country, both positive and negative.

<http://www.lse.ac.uk/collections/hellenicObservatory/pdf/GreeSE/Gr eeSE35.pdf>.

R. Karova: Energy Community for South East Europe: Rationale behind and implementation to date, *EUI Working Paper RSCAS 2009/12.*

The author provides a comprehensive overview of national and regional reforms in electricity systems in south-eastern Europe and the implementation of the Energy Community treaty.

http://cadmus.eui.eu/dspace/bitstream/1814/10912/1/EUI%20RSCAS%202009_12.pdf.

K. Jurin and N. Čučković: Comparative analysis of the quality of European institutions 2003-2009: convergence or divergence? *Financial Theory and Practice 34 (1) 71-98, 2010.*

This paper gives a comparative cross-country analysis of the quality of the institutional framework in selected EU and Western Balkan countries. The authors argue that while SEE countries have made significant progress in institutional reform, there is still much to do in this area to catch up with standards of old EU countries.

<http://www.ijf.hr/eng/FTP/2010/1/jurin-cuckovic.pdf>.

European Central Bank: Financial stability challenges in EU candidate countries, *ECB Occasional paper series No. 115, July 2010.*

An International Relations Committee (IRC) expert group of authors review financial stability challenges in Croatia, FYR Macedonia and Turkey. They show that, overall, the deterioration in asset quality has been managed well, and that the shock-absorbing capacities of the banking systems are fairly robust. However, given the major presence of foreign banking groups in these countries, they emphasise the importance of strengthening home-host cooperation.

<http://www.ecb.europa.eu/pub/pdf/scpops/ecbocp115.pdf>

RECENT ECONOMIC DEVELOPMENTS

Industrial production slow to recover. Many countries have recorded a rebound in industrial production in recent months, but from a very low base as compared to 2009 figures. Most prominently, industrial production in Montenegro increased by 41.6 per cent year-on-year in June, hence compensating for the sharp drop in 2009. This improvement, however, is mostly attributed to a base effect coming from the suspension of the country's sole thermo plant in May last year. Conversely, the Federation of Bosnia and Herzegovina (FBiH), Croatia and FYR Macedonia continue to record negative growth numbers, indicating a delayed recovery.

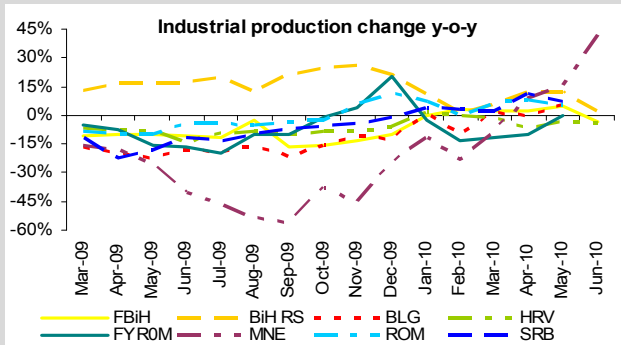
Exports up sharply in most countries. Exports across the region have increased significantly, having returned to positive growth rates in all SEE countries (see *Analysis* below). In Croatia and FYR Macedonia, the rise in exports has somewhat decelerated in the latest month for which data are available, but overall exports are anticipated to increase throughout the rest of the year, helping to compensate for weak domestic demand.

Inflationary pressures ease. Throughout 2009, headline inflation has come down substantially, primarily owing to the fall in domestic demand and consumer spending. 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. More recent data suggests that the CPI has accelerated again in all SEE countries, but is anticipated to remain moderate in the forthcoming months.

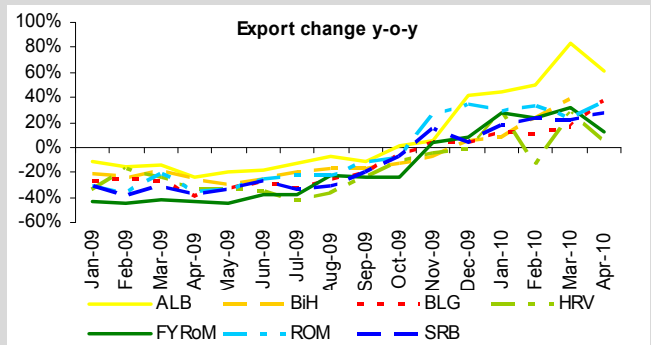
Risk perceptions have moderated but remain significant. Credit default swap (CDS) spreads for SEE's most advanced economies have increased significantly since the beginning of the global financial and economic crisis. Risks were reduced greatly since February/March 2009, however, due to negative macroeconomic indicators for Q1 2010, deteriorating fiscal positions as well as continuous concerns about potential spillover effects from the Greek debt crisis (especially for Bulgaria and Romania), CDS spreads have begun to increase again since April.

SELECTED MACROECONOMIC INDICATORS

Real Economy

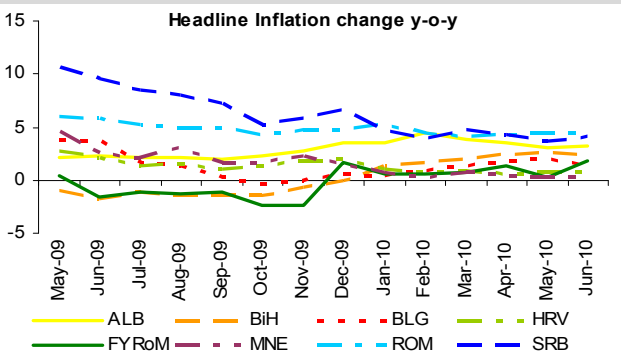


Source: National Statistical Offices.

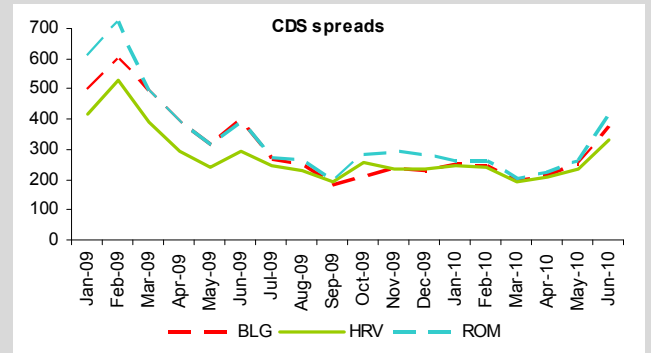


Source: IMF, National Bank of Serbia.

Inflation and CDS spreads



Source: National Central Banks.



Source: Bloomberg.

ANALYSIS: CAN EXPORTS PULL SOUTH-EASTERN EUROPE OUT OF RECESSION?

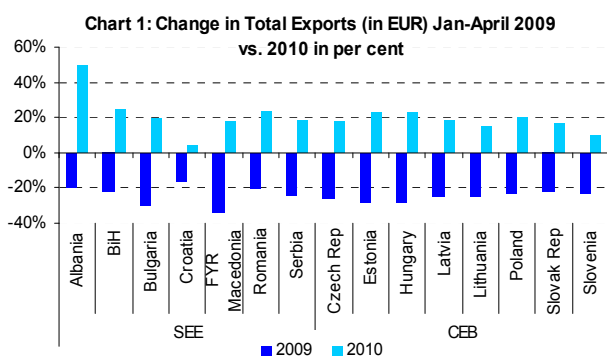
South-eastern Europe is lagging behind the rest of the transition region in terms of recovering from the effects of the global economic crisis. At present, it is hard to see any real signs of a robust recovery. The EBRD's latest forecasts for GDP growth this year, published on July 22, are significantly down on those produced just two months ago, reflecting the unwelcome flow of bad economic news in recent months. Table 1 shows that the three most advanced economies in the region – Bulgaria, Croatia and Romania – are forecast to have negative growth, ranging from -1.2 per cent in Bulgaria to -3 per cent in Romania. On a weighted average basis, the region is projected to record -1.5 per cent this year, compared to an average for the whole transition region (including SEE) of *plus* 3.5 per cent.

Table 1: Growth in real GDP in 2010

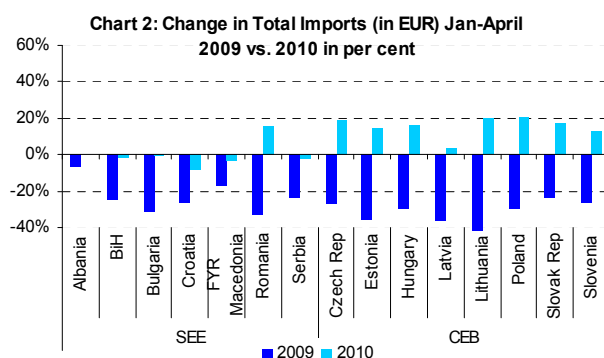
(EBRD forecasts as of July 22nd 2010)	GDP Growth (year on year per cent change)		
	2010 (May forecast)	2010 (July forecast)	Difference (% point)
Albania	1.4	1.4	→
Bosnia and Herzegovina	0.3	0.4	↑ 0.1
Bulgaria	-1.2	-1.2	→
Croatia	0.3	-1.3	↓ 1.6
FYR Macedonia	2.2	0.5	↓ 1.7
Montenegro	0.1	-0.1	↓ 0.2
Romania	0.0	-3.0	↓ 3.0
Serbia	2.1	1.9	↓ 0.2

One glimmer of hope comes from the external sector. This is the sector where the effects of the crisis in 2009 were most visible. Trade flows in SEE deteriorated dramatically throughout 2009, in particular in countries with strong economic ties to Western Europe and other advanced economies. On an (unweighted) average basis, exports from SEE and Central Europe and the Baltic states (CEB) fell by almost 20 per cent y/y, while imports dropped even more sharply by over 25 per cent y/y in 2009. Consequently, due to the generally higher share of imports, trade balances narrowed significantly.

Trade figures for the first four months of 2010 provide some evidence of a rebound. As illustrated in Chart 1, which shows the percentage change in exports y/y during the period January-April 2010 versus the same period in 2009, exports have accelerated and increased by approximately 20 per cent on average in 2010 so far. Although it appears that the rebound has not been strong enough to fully compensate for the fall in 2009, this provides clear evidence that exports are re-emerging. Interestingly, the chart also shows that the rebound in SEE is less uniform as compared to CEB: Albania, where exports increased by an impressive 50 per cent y/y in the first 4 months of 2010, benefited in particular from a significant increase in the export of electricity, as the country's hydropower generation dams produced at full capacity throughout much of the reported period. In contrast, exports from Croatia increased by just below 9 per cent y/y during the same period.



* Data on BiH refers to the period Jan-March. Data on Montenegro not available.
Source: Eurostat, IMF, National Bank of Serbia.



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Source: Eurostat, IMF, National Bank of Serbia.

With regard to imports, Chart 2 reveals an interesting difference between CEB and SEE. Whereas imports to CEB have increased by an (unweighted) average of almost 16 per cent y/y, hence somewhat compensating for the collapse in 2009, imports to the SEE region remain largely subdued. With the exception of Romania, where imports in the first four months of 2010 have been largely generated by an increase in natural gas imports, import flows appear to have stagnated or even continue to record negative year-on-year growth rates.

How can this difference between the two regions be explained? A gradual rebound in domestic demand and improving consumer confidence appear to be the main drivers for the recovery in the CEB region, where growth this year is now forecast by the EBRD at 1.9 per cent. In contrast, domestic demand remains weak in SEE, which underlines the risks and vulnerabilities the region is exposed to. Firstly, remittances – a vital source of income for many households in the region – are anticipated to fall substantially during 2010. Secondly, comprehensive fiscal consolidation measures recently implemented, most prominently in those countries with an IMF Stand-By Agreement (Bosnia and Herzegovina, Romania and Serbia) but also in Croatia and Albania, are expected to further translate into the real economy and dampen consumer spending. The austerity measures enacted recently in Romania – cuts in public sector wages of up to 25 per cent and a five percentage point increase in the VAT rate – form a major part of the reason for the worsened short-term outlook, necessary though these measures are for longer-term fiscal sustainability.

In order to understand the importance of exports for the region, it is worth looking at the composition of exports during the period January–May 2010.¹ The aforementioned increase in electricity exports – up more than 250 per cent y/y – was the main driver behind Albania's export boost. In addition, exports in construction materials and metals contributed to the rise in exports and increased by 147.1 per cent compared to the same period in 2009. In Bosnia and Herzegovina, agriculture and mining of metal ores were the main sectors recording export growth (148.3 per cent and 71 per cent respectively). Data from the statistical offices in Bulgaria and the FYR Macedonia equally indicate that crude materials – the main source of exports in both countries – increased significantly by 87.5 per cent and 122.8 per cent y/y. In Serbia, too, exports in electricity, gas and water supply as well as mining and quarrying recorded the most significant rise (113.6 per cent and 84.3 per cent respectively). Conversely, in Croatia, the modest recovery has been mostly attributed to an increase in manufacturing, whereas in Romania, exports have rebounded mostly due to increasing external demand for chemical products.

The metal industry plays a crucial role in many SEE economies, in particular in Bosnia and Herzegovina, FYR Macedonia, Montenegro and Serbia and the export of aluminium, iron and steel has been an important component of total exports in previous years. The analysis above clearly shows that external demand for these products has accelerated, which seems to be a driving factor behind the resurgence of the export market. Prices for commodities are anticipated to increase this year, according to IMF projections², giving a further boost to exports from the region and, it is hoped, supporting the SEE region on its way to recovery. However, it is difficult at present to foresee a return to robust rates of GDP growth before late-2011 at the earliest.

¹ For Bulgaria and Romania, data are available until April 2010 only; all numbers in this paragraph are calculated using the respective local currency, therefore not taking into account any significant exchange rate fluctuations.

² WEO Update July 2010, IMF, Washington D.C.