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Balkan Volatility: The Deepening Crisis in the European Super-periphery

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Introduction

Since early in 2010, the global economic crisis that began in 2007 has transformed itself into a specific crisis of the eurozone. In this paper, we investigate the impact of the eurozone crisis on the transition economies of the Western Balkans, a set of countries that form part of the European 'super-periphery' (Bartlett 2009). This set includes countries of the Western Balkans and the European Union (EU) eastern neighborhood countries that are not EU members. All of them have achieved some degree of EU integration, and most are candidate or potential candidate countries for EU membership. The economies in these countries are characterized by a high degree of euroization[1] that has made them highly vulnerable to all the negative effects of the eurozone crisis, yet without the support from the various EU bailout funds, the European Central Bank (ECB), and other policy instruments that are available to ease the impact of the crisis on the 'peripheral' EU member states such as Greece, Ireland, Spain, Portugal, and Italy. While the eurozone crisis has had a damaging effect on its weaker members in the EU periphery, it has not been widely recognized that it has had an even more damaging effect on countries outside the zone, especially those in the European 'super-periphery.' In several of these countries (Bosnia, Macedonia, and Serbia), unemployment currently exceeds 25 percent – a position worse than in Greece or Spain. Countries in the super-periphery are especially vulnerable to the effects of the eurozone crisis due to the effects of euroization, which is particularly

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The ideas in this paper were presented at the Atlantic Council's workshop, "Moving the Balkans and Bosnia Forward: A Post-Dayton Roadmap" on November 13-14, 2012. Done in conjunction with the US Army War College, the workshop brought together forty top US and European experts and policymakers to identify regional and national initiatives that could encourage the Balkans region to continue on the path toward euro-Atlantic integration.

[1] Montenegro and Kosovo have adopted the Euro as legal tender without the approval of the European Central Bank; Bosnia has a currency board which ties its currency to the Euro. Other countries in the region have little room for maneuver as a large proportion of domestic liabilities are denominated in euro. Croatia and Macedonia therefore have fixed pegs to the euro. Only Serbia and Albania have flexible exchange rates.

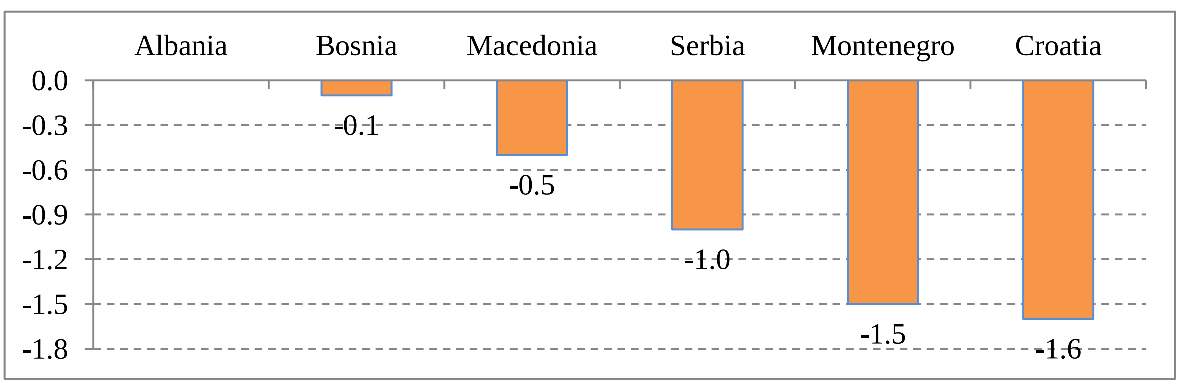
pronounced in the Western Balkan countries. In Serbia, for example, more than 80 percent of all private sector loans are denominated in a foreign currency (Brown and De Haas, 2012), while in Montenegro the euro is officially legal tender. Euroization makes it hard for countries in the super-periphery to achieve a real devaluation, and so internal devaluation through domestic recession and reduction of unit labor costs is the only way to restore international competitiveness. In doing so, however, these countries must manage without the support of the EU for debt reduction and so must impose even harsher austerity programs than those attempted in Greece. They must also design their own programs to ensure structural reforms that could underpin renewed economic growth, which is the only way to escape the vicious circle of debt, austerity, and recession.

The first effects of the financial crisis on the Western Balkan countries brought a substantial lag but were generally not very significant until 2009 (Prica and Backović, 2009). The intensification of the eurozone crisis throughout 2011 and the first half of 2012 has had a predictable impact on the Western Balkan economies. Already weakened by the effects of the global financial crisis on external trade, FDI inflows, and remittances, they have been hit again by the renewed slowdown in the EU. For example, in the first quarter of 2012, the Serbian GDP fell by 1.3 percent with prospects for a further fall in the second quarter, heralding a new recession at a time when unemployment is already above 25 percent.

Domestic economic performance: growth and unemployment

GDP growth: Economic growth in the Western Balkans underperformed earlier expectations in 2012 due to the bigger than expected slowdown in the eurozone. In April 2012, the International Monetary Fund (IMF) World Economic Outlook (IMF, 2012a) published a revised forecast predicting a contraction of 0.3 percent GDP for the eurozone in 2012. This contraction has quickly spilt over into the Western Balkans where growth forecasts of major international institutions such as the European Bank for Reconstruction and Development (EBRD) have been downgraded accordingly (see Figure 1).

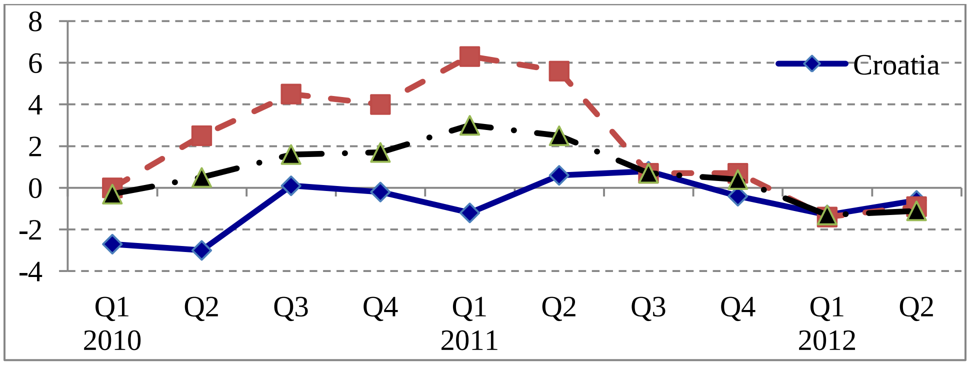
Figure 1: Economic growth forecast downgrades January 2012 – May 2012 (p.p.)



Source: EBRD Regional Economic Prospects, May 2012. Note the figures represent the downgrades in growth forecasts in percentage points.

The latest quarterly economic data indeed reveals that in major economies in the Western Balkans, the prolonged effect of the slowdown as well as the renewed recession in the eurozone have had a deepening impact in the Western Balkans, which entered recession in the first quarter of 2012 (see Figure 2).

Figure 2: Quarterly GDP growth rates (year-on-year, %)

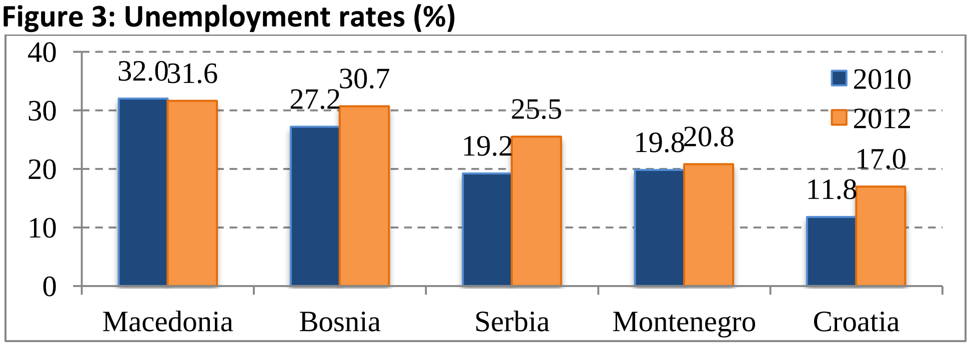


Source: EBRD Regional Economic prospects, July 2012 and national statistical sources.

Croatia, already struggling, saw its GDP plunge once again with a year-on-year contraction of 1.3 percent in the first quarter of 2012, mainly due to a fall in exports which fell by 3.5 percent; the largest falls in output took place in the industrial and construction sectors. In Serbia, the central bank forecasts a contraction of 0.5 percent of GDP for the year as a whole. In Macedonia, GDP contracted by 1.4 percent in the first quarter of 2012, compared to the first quarter of 2011.

Unemployment: The situation in the labor markets in Western Balkans has also deteriorated. Data from Labor Force Surveys (LFS) shows increased rates of unemployment in all countries in the region. From 2010 to 2012, unemployment fell only in Macedonia, which nevertheless still had by far the highest rate of unemployment at 32 percent in the latter year (see Figure 3). Even there, unemployment has begun to increase again. Unemployment in Bosnia and Herzegovina is approaching similar levels, having breached the 30 percent level in the first half of 2012. Unemployment has also shown dramatic increases in Serbia (from 19.2 percent in 2010 to 25.5 percent in 2012) and in Croatia (from 11.8 percent to 17 percent) over the same period.

Figure 3: Unemployment rates (%)



Source: National Statistical Offices, Labour Force Survey data.

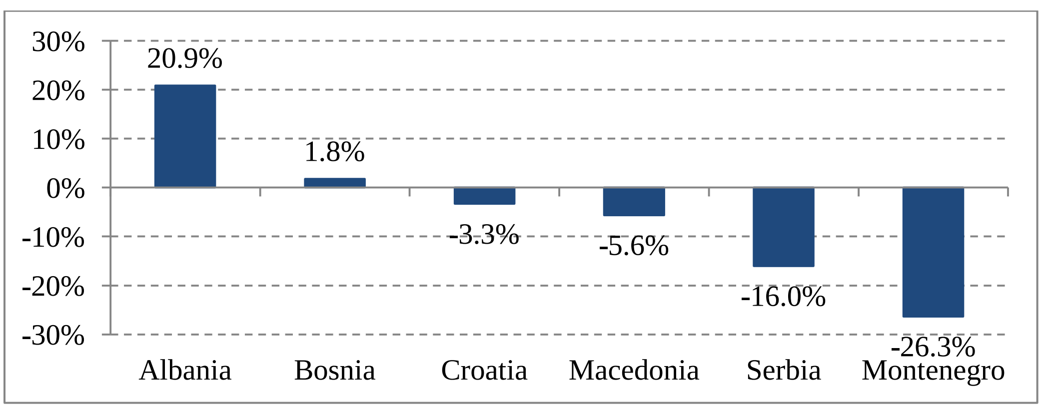
These data reveal that unemployment has reached far worse proportions in the Western Balkans than even in those countries of the EU periphery that have been worst affected by the eurozone crisis. In the eurozone as a whole, the unemployment rate reached 11.2 percent in mid-2012.[2] In Greece, the unemployment rate reached 22.5 percent in April 2012; in Spain, the rate of unemployment was 24.8 percent in June 2012, the worst in the eurozone. These extremes were exceeded in Bosnia and Herzegovina (30.7 percent), Macedonia (31.6 percent), and Serbia (25.5 percent), providing further evidence of the dire position of the Western Balkan countries in the European super-periphery.

Youth unemployment has increased to even more dramatic levels. The unemployment rate of those aged fifteen to twenty-four in Bosnia and Herzegovina was 57.9 percent in 2011,[3] 40.4 percent in Q1 2012 in Montenegro,[4] and 45.2 percent in Q1 2012 in Croatia.[5] In Serbia, the unemployment rate of twenty to twenty-four year olds in 2011 was 48.8 percent.[6] In comparison, in the eurozone the youth unemployment among under twenty-fives was 22.4 percent. The situation, however, reached astronomic proportions in Greece and in Spain, where in June 2012 youth unemployment reached 51.5 percent and 52.7 percent, respectively, which is even higher than in the Western Balkan countries (with the exception of Bosnia and Herzegovina).

External economic performance: exports, FDI, and debt

Exports to the euro area as a whole fell in most countries in the region between the first quarter of 2011 and the first quarter of 2012. The most seriously affected countries have been Montenegro and Serbia, whose exports to the euro area fell by 26 percent and 16 percent respectively over that period. The exception to this contraction of trade has been Albania, whose exports to the euro area have increased in that period. Albania's exports are very small, so there may be low base effects appearing here. In addition, almost all of Albania's exports go to Italy, and there may be specific factors that have affected Albanian exports to this country (such as inelasticity of particular exports).

Figure 4: Exports to the Euro Area (% change, 2012q1/2011q1, Euros)



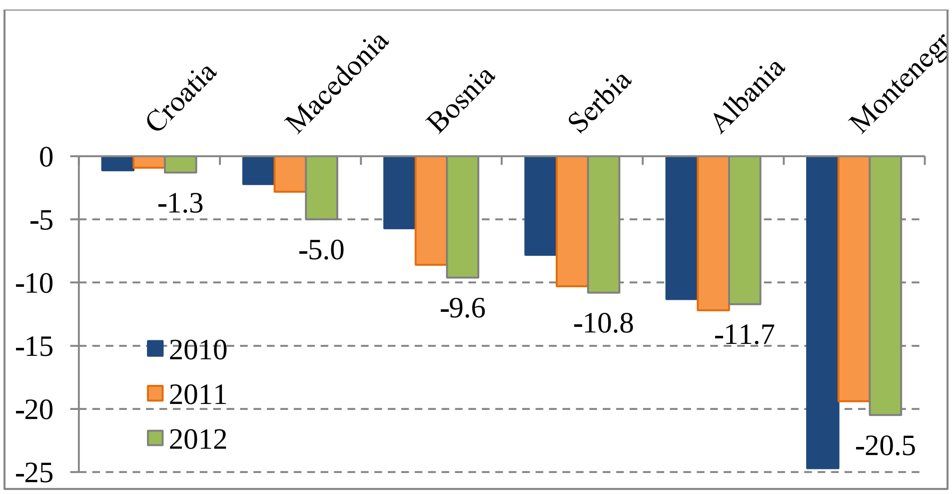
Source: IMF Direction of Trade Statistics (DOTS), adjusted for end of quarter exchange rates.

[2] Eurostat (2012) "euro area unemployment rate at 11.2%", News Release 113, 31 July
[3] Agency for Statistics of Bosnia and Herzegovina (2011), "Labour Force Survey: Final Results," November, Thematic Bulletin TB10
[4] Montenegro Statistical Office, (2012) "Labour Force Survey 1st Quarter 2012," Release No. 159, 15 June
[5] Croatian Bureau of Statistics (2012), "Labour Force Survey," First Release No. 9.2.7/1, 19 July
[6] Statistical Office of the Republic of Serbia (2012), "Labour Force Survey 2011," Bulletin 550, Table 2.1

Remittances from migrant workers abroad to their home countries have also made a significant contribution to the current account balance on international payments. This reaches significant levels in several countries such as in Bosnia and Herzegovina, where remittances account for 12.9 percent of GDP, Albania (10.9 percent), and Serbia (10.4 percent), each with a contribution of remittances exceeding 10 percent of GDP in 2010. Between 2010 and 2011, remittances held up well and even increased in absolute terms in every country except Croatia. However, it seems likely that remittances may fall in 2012 as the eurozone enters recession since many migrant workers are employed in the eurozone countries (for example, Albanian migrants are increasingly losing their jobs in Greece).

Current account deficits: Current account deficits have continued to increase in 2012 (see Figure 5) despite the fact that they are in crisis, mostly due to high government spending and political inability to curb it. Since FDI has been falling in most countries (but not all), the increased deficits were more often than not financed by additional government borrowing, which has led to an increase in external debt to sometimes prohibitively high levels (especially during the crisis), as we discuss in the next section.

Figure 5: Current Account Deficits, 2010-12 (% GDP)

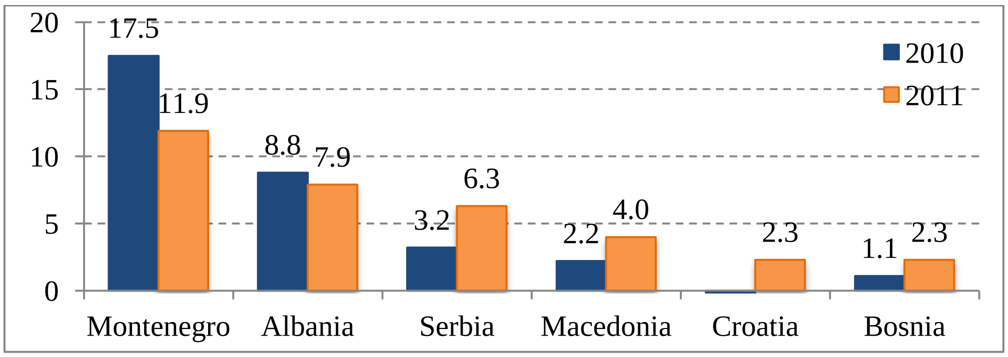


Source: Candidate and Pre-Accession Countries Economic Quarterly, 2012 Quarter 2, European Commission ECFIN Unit D-1, 6th July 2012 and ECFIN (2012b); World Bank Macedonia country report No. 12133; data for 2012 are latest estimates.

The high levels of the current account deficits in Montenegro and Albania have been sustained by a continuing inflow of FDI into those countries, albeit at a lower level than before the onset of the crisis. In Croatia and Macedonia, current account deficits fell to relatively low levels in relation to GDP, which was in line with the lower levels of FDI inflows into those two countries. The high current account deficits in Bosnia and Herzegovina and in Serbia were partly financed by IMF loans supplemented by funds from the World Bank and the EU.

Foreign direct investment: One of the main consequences of the global financial crisis of 2008 to 2009 was the collapse of international capital flows and a sharp reduction in global FDI flows (Milesi-Ferretti and Tille, 2011). This was reflected in the Western Balkans with a reduction in FDI inflows during these years (Prica and Uvalić, 2009; Bartlett and Monastiriotis, 2010; Bartlett and Prica, 2011). The contraction in FDI inflows continued in Albania and Montenegro in later years, while other countries that had been hit harder by the initial bout of the global financial crisis saw some recovery in FDI inflows in relation to GDP between 2010 and 2011. Altogether, the levels of FDI in all countries were far lower than in the pre-crisis period.

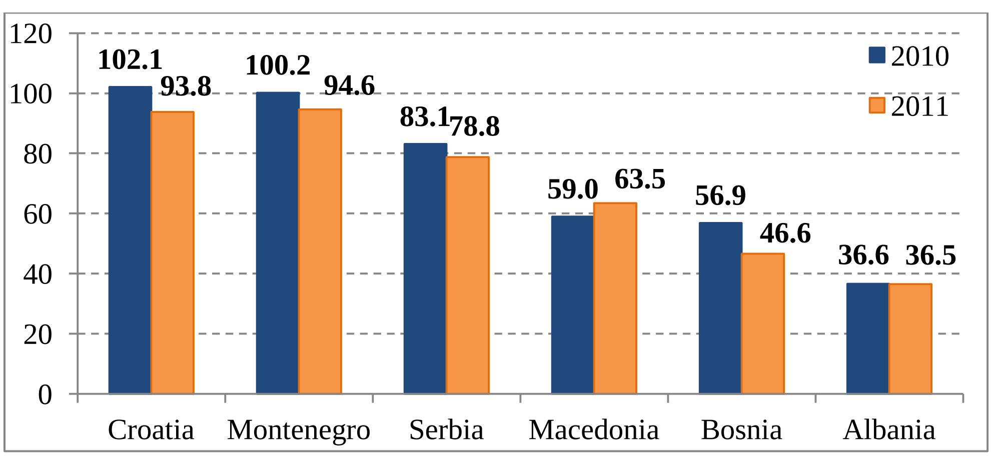
Figure 6: Foreign Direct Investment, 2010-11 (% GDP)



Source: Candidate and Pre-Accession Countries Economic Quarterly, 2012 Quarter 2, European Commission ECFIN Unit D-1, 6th July 2012.

International debt: The external debt position of countries in the Western Balkans is quite varied, ranging from almost 95 percent of GDP in Croatia and Montenegro to just 37 percent of GDP in Albania. The largest external debt was that of Croatia, whose public and private sector external debt had reached an astonishing €47.4 billion by the end of April 2012, which is an increase of 4 percent since the end of 2011 and is due to new central government borrowing.[7] As seen in Figure 7, critically high external debt positions are also found in Montenegro and Serbia. With both of these countries having continuously large trade and current account deficits, these are alarming figures indeed. Macedonia and Albania are fast approaching these dangerous levels as well.

Figure 7: External Debt (public and private, % GDP, 2011)



Source: EBRD Regional Economic prospects, October 2011 and July 2012.

[7] Croatian National Bank Bulletin No 183, 2012.

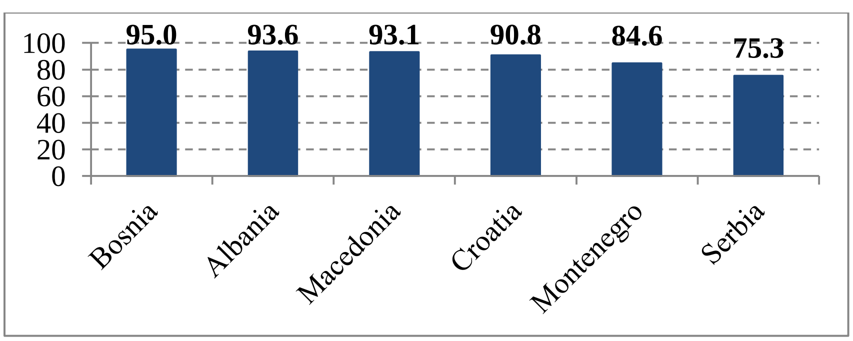
Despite its high level of external debt, Croatia has the highest sovereign investment rating as defined by Standard & Poor, although the rating is the lowest rank of investment grade and is on a negative watch. All the other countries in our pool are still in the speculative grade, with Bosnia and Herzegovina at the bottom of the list.

The financial sector in the Western Balkans

There is a very high concentration of bank ownership by foreign banks in all Western Balkan countries, and this gives a very negative outlook for their economic development in the current situation.[8] Various quarters have expressed concern about the vulnerabilities this poses to the economies in case the support of parent banks, through continued refinancing of foreign currency loans to domestic affiliates, should be significantly reduced (Ćetković, 2011). The Vienna Initiative agreement in 2009 and the Vienna Plus agreement in early 2012 were designed to persuade parent banks, mainly based in Italy, Austria, and Greece, to remain engaged in the region. Most reports of international organizations such as the IMF and the EBRD insist that local banks are well capitalized and liquid with high levels of provisioning against potential losses, and that the foreign banks' operations in the region are highly profitable due to the high interest rates charged on domestic loans and their virtual monopoly (oligopoly) position on the market. Nevertheless, the incidence of non-performing loans (NPLs) is increasing sharply throughout the region, and concerns are no longer so easy to gloss over. In a recent IMF statement on Croatia following a visit of the IMF mission to the country, these concerns have become visible:

The sizable dependence of banks on external financing exposes them to the risk of contagion from the euro area (interest and rollover risks), especially if concerns about the sovereign debt adversely affect the euro area parents of Croatian banks. Potential difficulties in obtaining refinancing at affordable interest rates could lead to excessive or disorderly deleveraging, complicating macroeconomic recovery. In the context of weak growth prospects, the risk of further deterioration in asset quality also remains material. (IMF, 2012c)

Figure 8: Share of assets of foreign-owned banks (%)

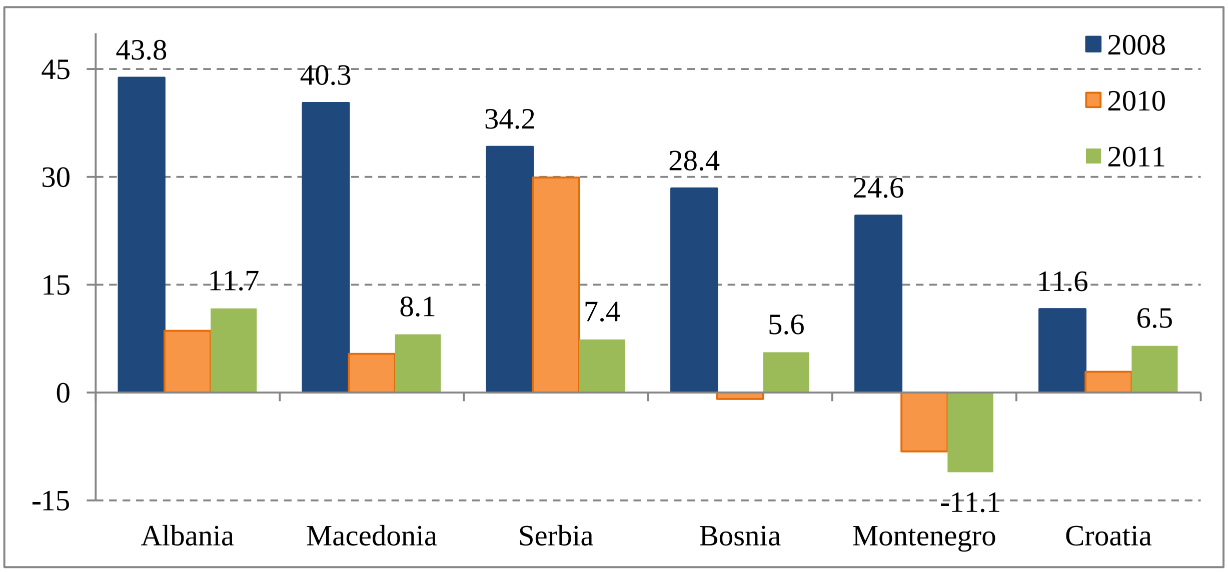


Source: EBRD online data.

[8] According to the EBRD: "The short-term economic prospects for the SEE region remain weak, and vulnerabilities have increased as a result of the eurozone crisis. Financial sector vulnerabilities are a particular concern, given that the vast majority of the banking system is foreign-owned and given the reliance in most countries on funding from abroad" (EBRD Regional Economic Prospects, May 2012).

During the global financial crisis, credit collapsed in the developed countries, and this spilled over into the Western Balkan region. As most of these banks are based in the eurozone, the credit contraction has continued with the progression of the eurozone crisis, and the continuing difficulties faced by the eurozone parent banks has inhibited the resurgence of credit up to the present date. As illustrated in Figure 9, by 2011 the rate of credit growth had fallen to single digit figures in all countries except Albania where credit growth reached almost 12 percent, and Montenegro where credit continued to actually contract as it had done in 2010. According to a World Bank assessment, "credit growth is likely to remain weak, and the financial sector, increasingly dependent on local deposits as deleveraging of European banks continues, will have at the same time to deal with elevated NPL levels" (World Bank 2012a: 39).

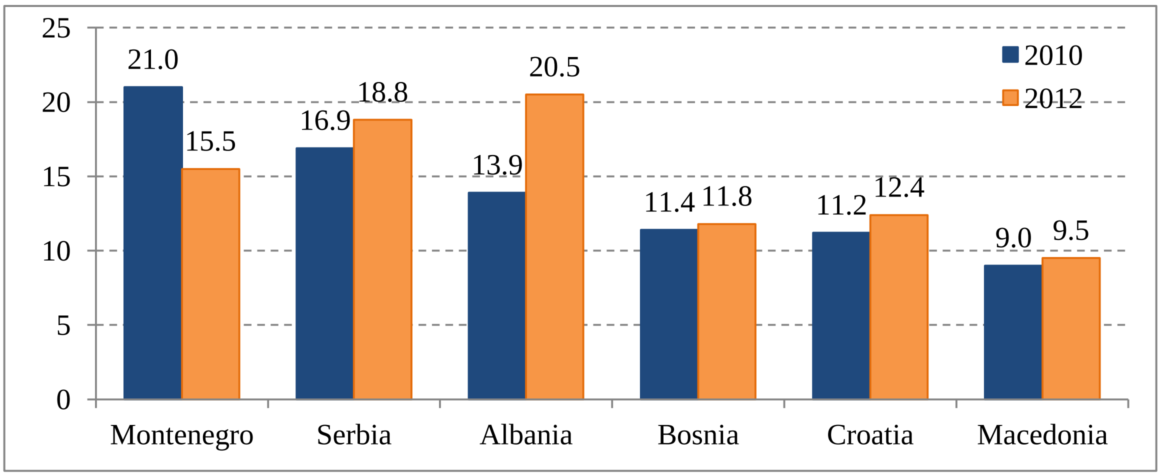
Figure 9: Collapse of credit growth, 2008, 2010 and 2011 (growth rates % p.a.)



Source: Candidate and Pre-Accession Countries Economic Quarterly, 2012 Quarter 2, European Commission ECFIN Unit D-1, 6th July 2012.

Non-performing loans (NPLs) have risen rapidly as the effects of the economic crisis have worsened and both companies and households have experienced increasing difficulties in paying back their loans. A range of legal, judicial, and regulatory obstacles reflecting lack of protection for creditors has led to significant delays in NPL resolution (EBCI, 2012). The rise in NPLs has put strain on the balance sheets of banks and has inhibited them from increasing the rate of credit growth, which has shrunk to low levels as already shown. This means that in the affected countries, small businesses are finding it hard to obtain credit to finance expansion and growth, or simply to stay in business. This in turn places another break on economic growth in the region. The issue does not yet seem to be causing critical problems for banks operating in these countries, which have built up large capital buffers on the basis of their highly profitable operations in the region. In Croatia, 20 percent of corporate loans were non-performing in September 2011 (CNB Financial Stability Report January 2012, p. 44), while only 8.5 percent of household loans were non-performing. However, within the category of household loans, mortgage loans were badly affected by the sharp drop in the house prices of around 20 percent from the peak in 2007, amounting to the bursting of a property bubble. The real estate property prices have dropped in all these countries due to the crisis, while mortgage holders who had indexed their loans in foreign currency were the most vulnerable. This was especially the case earlier on for mortgages that were indexed in Swiss Francs and that, albeit for a brief time, appreciated sharply against the domestic currencies, causing a panic amongst the debtors and their governments that had to introduce emergency measures to deal with this issue until the value of the Swiss Franc was fixed against the euro.

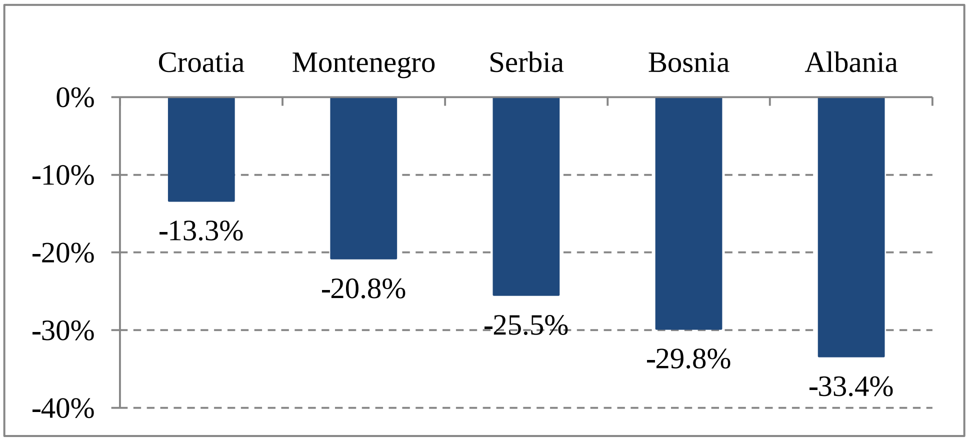
Figure 10: Non-performing loans as % of total loans, 2010 and latest data for 2012



Source: IMF Regional Economic outlook, October 2011 and EBRD Regional Economic prospects, July 2012. Note: data for 2012 refer to latest available data.

A significant new factor in relation to the developing eurozone crisis is the phenomenon of deleveraging by eurozone parent banks that operate in the Western Balkans. According to the IMF, "Central and Eastern Europe are the most exposed to the euro area and could suffer disproportionately from an accelerated withdrawal of bank funding or portfolio capital" (IMF, 2012b: 5). Deleveraging can come about through reductions in cross-border flows of interbank funding, nonbank private credit including trade finance, and also through reduced public sector lending (IMF, 2012a; World Bank 2012b). The incentives on parent banks to pursue this strategy are varied. Firstly, market funding has become more costly due to adverse feedback loops between the sovereign debt crisis and banks. The rising costs of raising funds from wholesale money markets have therefore become less attractive as a source of funds compared to local deposits than in the past. Secondly, eurozone banks are relatively undercapitalized, and more stringent regulations require them to raise their capital reserves to meet the Basel III requirement of 9 percent Tier 1 capital ratios, which limits their ability, or attractiveness, to provide loans to cross-border affiliates. Thirdly, as bank equity values have fallen, it has become more difficult for them to raise funds on private markets to build capital buffers against potential sovereign defaults. Furthermore, weakening economic performance leading to possible sovereign downgrades in the Western Balkans could increase country risk factors in decisions of parent banks to remain engaged in the region.

Figure 11: Deleveraging in all sectors of BIS reporting banks (change in external net assets, 2009-2011)



Source: Bank for International Settlements (BIS) online data. Note: data refer to gross assets minus gross liabilities.

An example of the tightening of conditions due to the eurozone crisis comes from actions taken by the Austrian National Bank, which in mid-November 2011 imposed tight curbs on home banks' ability to lend in Central and Southeastern Europe (CSEE), instructing Erste Bank, Raiffeisen Bank International, and Bank Austria (a subsidiary of Unicredit) to boost capital reserves and limit cross-border loans in the CSEE region (FT, Nov. 22, 2011). The regulation requires that Austrian bank subsidiaries in emerging Europe must limit the ratio of new loans to deposits to no more than 110 percent. Cross-border credit was expected to fall by up to one fifth as a result. In short, generally the deleveraging of EU banks in order to conform with the new EU capital adequacy requirements (Basel 2.5 and III), as well as due to the current market conditions, will necessarily result in a significant lowering of their exposure to the Western Balkan countries, which will in turn further reflect negatively on the price and availability of capital in these countries, regardless of the Western Balkan daughter banks' capitalization and/or profitability. The extent of deleveraging in 2009 to 2011 is illustrated in Figure 11. During this period, the volume of external funding by parent banks fell by more than 20 percent in Albania, Bosnia and Herzegovina, Montenegro, and Serbia. In the first quarter of 2012, the pace of deleveraging slowed down due to the policy measures introduced by the European Central Bank in December 2011 in the form of long term refinancing option (LTRO) funding of the eurozone banking system through the provision of €1 trillion in low-cost three-year loans (the LTRO program). Some of this funding found its way into the banking systems in the Western Balkans, providing a temporary respite. Nevertheless, the pace of deleveraging picked up again in the second quarter of 2012.

A worsening of the eurozone crisis would exacerbate these trends. According to the latest EBRD Regional Economic Prospects report, if the eurozone crisis is not contained and spreads to large eurozone countries (such as Spain and Italy), it could render "several large European banks insolvent. Major parent banks would accelerate deleveraging in the region, triggering a credit crunch and recession in emerging Europe. . . . A negative eurozone crisis scenario would affect CEB and SEE countries . . . [through] . . . depressed exports and financing inflows" (EBRD 2012: 3).

Conclusions

As the data presented above unambiguously show, the eurozone crisis has hit the Western Balkan countries of the EU super-periphery extremely hard, with record falls in GDP growth rates compared to the rest of Europe, combined with extremely high and increasing unemployment levels. Furthermore, should the crisis in the EU be no worse than it is now, the prospects are that by the end of this year, the economic performance will deteriorate further so that the situation in Greece and Spain would pale in comparison.

Lacking the domestic political will and know-how to deal effectively with the crisis and without recourse to the EU stabilization mechanisms (neither to the bailout funds nor to low-cost refinancing from the ECB), these highly euroized economies are bearing the full brunt of the eurozone crisis unprepared. Furthermore, they lack any substantial internal buffers, which were used up during the prolonged exposure of these small, open economies to the first phase of the global financial crisis (for example, debt has already increased to unsustainable heights in several countries). Dependency on the EU at this time of crisis also brings dangers in terms of increased vulnerabilities to downturns in the eurozone, which is especially problematic for the countries in the region as the negative effects of EU monetary integration seem to have particularly amplified effects in the European super-periphery. In the absence of significant additional external aid, we can expect social unrest and political upheavals the likes of which we have not seen in Europe in recent years.

What are the possible ways out? The only rational approach that we can see — in the absence of significant and substantial EU assistance on the scale provided to countries such as Ireland, Portugal, and Spain — would be that the countries of the Western Balkans, and of Southeastern Europe as a whole, including Greece, should consider ways in which they can work together to boost regional growth.[9] Regional cooperation in this part of Europe could be an alternative to the dependence of each individual country on the EU.[10] Undoubtedly, there are political obstacles to such cooperation, but the benefits may be sufficient to overcome them, at least on the basis of practical economic programs such as regional infrastructure investments, creation of a regional labor market, sharing of research capacity, and creation of an integrated regional educational and training capacity. The aim would be to combine the considerable resources of the region in such a way to achieve economies of scale and promote externalities at a regional level in order to boost economic growth. However, once

[9] The idea of regional cooperation is not new, and has been actively promoted by the EU through its accession strategy for the region since at least the Thessaloniki declaration of 2003, and also through the instrument of the Stability Pact and its 'locally-owned' follow-on institution, the Regional Cooperation Council based in Sarajevo. The most successful achievement of this approach has been the formation of the CEFTA 2006 regional free trade agreement, although other regional cooperation initiatives have hardly gotten beyond the phase of declaratory statements of intent. The EU has also supported the Western Balkans Investment Fund to finance infrastructure projects at a regional level. However, the strategy of regional cooperation has not been accompanied by sufficient funds from the EU or by sufficient political willingness and initiative by the countries of the region themselves. In part, this is due to their adherence to the competing policy paradigm of national economic 'competitiveness' that sets one country against another on the international market place. The paradigm of economic competitiveness is promoted by numerous international organizations including the OECD, the World Bank and not least by the EU itself in partial contradiction to its own strategy of regional cooperation.

[10] Building further on and deepening the work of the Regional Cooperation Council and the Western Balkans Investment Fund

we move away from economic reasoning and bring in the political constraints, it is unlikely that the rational approach would be accepted as the individual political interests of each small country in the Western Balkans seem to often work only to their own detriment. And that is not a surprise — after all, a similar situation seems to prevail in the eurozone, with national political interests frequently trumping collectively rational solutions.

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