South Eastern Europe after the Crisis: a new dawn or back to business as usual?

WILL BARTLETT and VASSILIS MONASTIRIOTIS (eds.)
London School of Economics and Political Science: LSE European Institute, London, 2010, pp.125

Book review by VUK VUKOVIĆ*

* Received: April 22, 2011
  Accepted: April 26, 2011
The severity of the global financial crisis continues to spread consequences to various developing regions across the world that managed to dodge the first blow. The reason they did so was the relative underdevelopment of their financial systems and a relatively lower level of integration with the most developed countries, where the housing market started to collapse taking with it the interdependent financial system and consequentially a major part of the real sector. South Eastern Europe was one of these unfortunate regions that, although avoiding the initial downturn (a rapid decrease of GDP started in 2009, although in developed countries this had already begun in the first two quarters of 2008) continued to experience a more severe effect on fragile economies that mostly depended on foreign investments and a high level of government spending backed up by an increased accumulation of foreign debt. The model worked as long as GDP kept on growing. However, under the recently experienced exogenous shock this came to a stop and caused a far greater level of instability, and as the more developed nations continue to recover (some quicker, some slower, depending on the responses from their respective governments) the less developed regions still remain in economic distress, hoping for a speedy re-instalment of the pre-crisis system. Their answer to the crisis could be seen as an opportunity to trigger much needed changes in their pre-crisis growth models and to adopt the needed reforms.

This ambitious book edited by Will Bartlett and Vassilis Monastiriotis deals with the effects of the global economic downturn on the economies of South East Europe (SEE), the positions they were in before the crisis and the policies necessary for them to emerge from the recession. Each country is examined on a case-by-case basis and for each country the current policy response is evaluated, while a suggestion on future economic policies is given with respect to each country’s specific conditions.

The book is clearly structured and contains two main parts reflecting the individual pieces of the authors’ viewpoints on the recession issues in each of the SEE countries. Part A provides a good overview of the macroeconomic situation in the region and all the joint effects that have exaggerated the crisis’ impact on the region along with the necessary policy responses. A link between the Greek situation and SEE countries as well as the long-run growth prospects complete the portrait and already present a possible answer as to why the crisis might have even more severe consequences for SEE countries.

In part B each country is evaluated individually by economists from within the region. The similarity between these countries is that they all experienced high growth levels in the decade preceding the crisis. The impact differed from one country to another, relative to the level of integration, but the consequences are similar – lower availability of credit, rapid decline of FDI, increasing unemployment and higher import prices.
Each chapter can be seen as an individual paper analyzing the impact of the crisis on a specific country as well as all the preconditions, policies, pleas for recovery and lessons to be learnt. Each one of them tries to analyze its respective country with maximum precision. The level of analysis is quite robust as every author tries to determine the reasons why the crisis had (or did not have) a big impact and whether it was entirely the crisis to blame for the level of economic distress each country is experiencing or whether it has merely been a consequence of inefficient pre-crisis policies that the crisis only exacerbated. They also analyze the policies and responses to the crisis currently being undertaken and strive to offer their own views on what is to be done in order to reach a stable medium-run recovery.

The book follows a pattern: the beginning of each chapter takes its respective country in the perspective of the entire region and then moves on to its inner issues trying to lead the reader to reach a conclusion on what is to be done to trigger recovery. The editors have organized the entire book this way, presenting at the beginning a full view on what is wrong with the region along with its recovery and growth prospects. They then assign the first three chapters to a closer consideration of the region’s instabilities, in a wider focus.

The level of impact the global recession had on South East Europe affected some countries more while others only slightly. The EU member countries and candidate countries seem to have experienced more severe consequences than the rest of region, verifying a higher level of economic integration with the EU as a possible cause of this. As the global financial situation worsened, the impact struck these countries indirectly as their banking systems were not exposed to toxic assets. The indirect effect came through a contraction of international trade, a halt of credit growth (due to global restriction of credit), a rapid decrease of foreign direct investment as well as a decrease of remittances from migrant workers. The current growth model for most of the SEE countries relied upon an expansion of domestic demand driven by credit expansion from banks and external funding (FDI capital inflows – mostly through privatization, EU assistance, remittances and debt accumulation by both the citizens and the government). The inflow of these foreign resources led to an artificial expansion in consumption and the creation of external debts, low savings and rising deficits. Such dependence made the SEE countries more vulnerable to external shocks. The consequences are still hurting these economies as increasing unemployment, rising import prices and reduced access to credit leads to rising inequality and social turmoil around the region. The main lesson the book’s editors and authors imply is that the old growth model has come to an end and that there is an increasing need for new reforms to strengthen the region and make it more capable of withstanding future exogenous shocks.

Recovery varies on the level of impact the crisis had and the relative level of integration and interdependence some countries had with developed nations (the EU in particular). Since credit growth and FDI inflows are unlikely to recover soon
this can imply that the most developed countries within the region, namely Bulgaria, Croatia and Romania (EU members and a candidate) will continue to experience the recession effects for yet another year without much hopes of a quicker recovery unless their governments apply the needed reforms.

Policy responses also vary and are dependent of the transmission mechanisms of the crisis and the level of responsiveness of each country’s respective government. Some countries allowed the fiscal deficit to rise to increase aggregate demand (Macedonia, Montenegro, Albania), while others seek support from the IMF (Bosnia, Serbia, Romania) and some used rational monetary policies due to a lack of effort by the government (Croatia) and cancelled restrictions on bank lending to domestic enterprises in foreign currencies. The practical impact has been to run down domestic foreign currency reserves in the face of the collapse in the external supply of foreign funds.

The policy responses currently being undertaken seem to be only temporary solutions, which depend on a relatively quick return to pre-crisis conditions and growth models. However, the editors and the authors clearly recognize that if this doesn’t happen (which is likely) more fundamental reforms will be needed to ensure future economic growth in the SEE region.

Part A of the SEE region analysis starts with chapter 2 where Ben Slay covers the economic and social impacts of the crisis on the entire SEE region. He observes the main macroeconomic indicators, which lead him to believe that the effect of the crisis was much less severe for the SEE countries than for other EU member states. However, GDP growth in the region has declined, bringing the decade of growth in household income and employment to an end. Fiscal expansion was used as the main policy instrument to deal with the recession, leading to rising fiscal deficits. The situation may continue to worsen, as unemployment is increasing and the social programs, pensions and health care programs are putting additional pressures on fiscal sustainability. The recovery is dependent on higher export growth to support the rising demand of the EU-15 countries. Since the pace of recovery of the Euro area countries seems to be slow, the prospect of recovery for the SEE region is also in doubt. Slay additionally covers the socio-economic problems in the chapter and he expects them to worsen in the coming years. However, he uses pre-crisis data on poverty and inequality. It is hard to make clear inferences on this without corresponding data but he tries to get around that and suggests the appropriate social policies that should take place to mitigate the effects of the crisis on the poor and misfortunate.

Peter Sanfey and Simone Zeh in chapter 3 focus on the policy dimension and emphasize the trade potential of the SEE countries as a way to push for growth again. The stable pre-crisis decade was characterized by capital inflows and credit expansion; however, post-crisis recovery cannot depend on these as it will be
quite some time before the pre-crisis levels of FDI and credit growth are restored. But the trade flows within the region are still low and the authors suggest a strong re-focus on this issue as a key way to achieve economic growth again. They offer a new growth strategy, realizing that the old one is not practical any more, for the crisis highlighted the vulnerabilities of previous growth models. They put the emphasis on relatively low levels of intra-regional trade and analyze the reasons behind this (non-tariff barriers are recognized as the main culprits). A path to faster growth and a more rapid way out of the recession, at the same time developing a new growth model, is achievable through higher levels of trade openness. Sanfey and Zeh even set out for policymakers how this is supposed to be done; on a multilateral, a European or even on a unilateral level. This may not only trigger a way out of the recession but it may also help the Western Balkan countries quickly to finish the EU accession process and create a more favourable environment to attract foreign investors.

In chapter 4, Laza Kekić examines the region’s recovery prospects from the perspective of the Greek crisis and its possible effects on the region. He shows weak growth prospects for the SEE countries and an additional risk in the potential fall-out from Greece (particularly for its closest trading and investment partners). He draws on the similarities of Greece and SEE countries concerning their common problems with corruption, tax evasion, unsustainable pension systems, ageing population, etc. Most of these countries haven’t yet experienced consequences anything like those experienced by Greece, but the dangers of increasing vulnerabilities still exist for the region due to the high involvement of Greek banks (as well as trade relations, remittances and FDI) in certain countries (especially the neighbouring countries, Albania, Macedonia, Bulgaria and Montenegro). The banks are opting to reduce their exposure in the region as it is unlikely they will continue credit expansion very soon as the pressures from the home market may forbid them from further expansion. Kekić concludes that the Greek situation may indirectly affect the chances of further EU enlargement, causing even more difficulties for some SEE countries whose recovery depends on quicker EU accession.

Part B of the book covers each country individually. It starts with chapter 5 where Etleva Germenji measures the impact the crisis had on Albania and immediately infers that due to Albania’s limited integration into the global market and its low level of financial market development, the impact of the crisis only had a moderate effect, keeping it relatively isolated from the financial meltdown. The economy did experience secondary effects to some extent due to a reduction of remittances (which account for 10% of Albania’s GDP), lower exports and slightly tighter domestic lending policies (caused by lower liquidity and higher credit risk of investing in the real sector). These secondary effects did have an impact on rising unemployment (especially in construction and export related industries) that may even lead to social turmoil due to a rising level of political instability. Through the course of a fiscal stimulus the government raised the budget deficit increa-
sing the public debt and, due to an increase in borrowing costs, found it difficult to raise new funds on the international capital market. Germenji denotes that the government decided on a fiscal stimulus not only to boost demand but also in anticipation of the parliamentary elections that were held in June 2009. In the end, this did provide a boost to economic growth as Albania turned out to be one of the two countries in the region that experienced GDP growth in 2009 (around 3%). The Bank of Albania also worked in its favour by increasing liquidity and cutting down interest rates. Although the economy is projected to grow over the next two years (implying a V shaped recovery) Germenji fears that the current political crisis as well as potential spillovers from the Greek economic crisis (Albania’s major foreign investor) may alter these growth projections. She also rightly doubts that the current fiscal expenditure approach will be enough to eliminate the uncertainty over future growth.

Anto Domazet in chapter 6 analyzes the crisis in Bosnia and Herzegovina (BH) from a political economy perspective. He observes the situation in BH as a joint effect of the long-lasting political crisis and the global economic recession. The country is in a “middle income trap”, the level of poverty is increasing, unemployment is rising, wages are falling, there is uncertainty surrounding pensions and social transfers and finally there is complete lack of political ability to deal with the crisis as they focus more on their internal conflicts. Domazet does a good job in explaining the complexity of Bosnia’s fragile political situation as it is important to understand this before commencing any analysis of the BH economy and any exogenous shocks. He questions how long this can continue as the political elites are facing a collapse of the system they once strove for (he uses the term political capitalism). He says that changes are crucial, claiming there is now an opportunity simultaneously to deal with the declining economy and to reform the political system. Even though the situation is bad for BH, he still tries to find a glimmer of hope and a chance to overcome both the political deadlock and the economic downturn only if there is enough political support. A clear-cut point is made in the chapter: the political elites seem to be disillusioned about the actual causes of the crisis in BH and have adopted a “wait and copy strategy” to try and revive the economy in the short run (excessive government expenditure and slow privatisation). According to Domazet the way out of the crisis is in stimulating private entrepreneurship, strengthening market institutions and balancing the public sector at a lower level until the global recovery sets the local private sector in motion. The problem is that Bosnia’s economy doesn’t have the strength or the ability to manage the crisis this way but in order to do so it must engage in a deeper and more painful (painful for the ethnically fractionalized elites) constitutional reform. The idea is that one cannot fight the crisis effectively if the nation is already suffering from terrible mismanagement and inefficiency. Domazet however omits to stress the importance remittances have for BH in possibly alleviating the social consequences of the recession.
Similarly to the rest of the region, the relative immaturity of the domestic capital market (characterized by low liquidity, insufficient transparency, etc.) postponed the initial crisis effects on Bulgaria, analyzed in chapter 7 by Stoyan Totev and Grigor Sariiski. Compared to the previous two cases, Bulgaria was much more integrated into the EU thus experiencing a more severe effect on its economy (through diminishing capital inflows). A particularly negative impact was the deterioration of international trade. There was a decrease in consumer demand, restricted access to credit, decline of remittances, rising debt and rising unemployment. The authors recognize a fixed exchange rate as a reason for a slow recovery of the economy, placing additional difficulties on Bulgarian exporters. They also examine the possible consequences to Bulgarian banks and financial institutions, foreign investment and exports, the real sector and the labour market. They tackle the effects on the social situation, characterized by a reduction in rent incomes, decrease of the propensity to consume, rising unemployment and de-capitalization. The recovery is thus expected to be slow, particularly because of the effect of rapidly declining foreign investments (a key determinant of pre-crisis economic growth in Bulgaria) and a serious outflow of highly skilled labour. The authors end on the positive note that the crisis might generate an indirect healing effect on the economy as it can speed up the needed restructuring of production and trade. Another positive sign is the opportunity to take resources from EU structural funds, an option that has not been available for Bulgaria due to high corruption in the previous years. The authors are fully aware of the negative implications politics can create for the economy and are striving to persuade the reader that this needs to be changed in Bulgaria.

Katarina Ott tackles the problems facing Croatia in Chapter 8. The characteristics of Croatia are similar to those of other SEE countries; decrease of GDP, increasing budget deficit, high government expenditure, rising unemployment. Croatia’s pre-crisis situation could only extend and deepen these effects, making them long-lasting. The current account deficit was an issue long before the crisis, and the same goes for a large budget deficit and consequently a level of public debt well above the regional average. In line with the burden of the whole book, Ott also points out that, like other SEE countries, Croatia failed to fight its instabilities and failed to reform institutionally when the time was right. Accordingly Croatia now has much less breathing space to tolerate increased public expenditures; instead it must engage in budget cuts to curtail the deficits and repay its debts. The problem here is lack of political incentive to do so as these policies are highly unpopular and can lead to electoral defeat (even though a plausible economic recovery program was made, the biggest issue is its implementation). Ott develops the issue of the democratic deficit, which limits the effectiveness of any recovery program. The voters are not ready to make sacrifices. Her suggestion is that the citizens should “take the medicine” in order for the country to achieve a quicker economic recovery and future prosperity. However, even if the citizens are ready to do this, the government is still under immense pressure from various interest groups (war
veterans, unions, pensioners, coalition partners, etc.) and is reluctant to carry out its own reforms, hoping that the status quo will last long enough for them to ensure another election success. Finally, Ott recognizes that EU membership and the fulfilment of the Economic Recovery Programme (if properly implemented, not selectively which has been the case so far) are the medium run paths out of the crisis. None of these present a short run solution but for Croatia – there is no short run solution.

Petrit Gashi in chapter 9 on Kosovo focuses on the degree of economic integration. He investigates whether the crisis had any adverse impact on Kosovo. Although Kosovo was not immune to the effects of the crisis and international imbalances, the low level of economic integration of this newly formed country (that is yet to experience its own transition) made it experience only limited effects of the global recession and avoiding its full impact. The only effect was on decreasing trade and the level of remittances (especially because Kosovar unskilled migrants abroad are the most likely to suffer downturns in the labour market). And although the crisis seems to have dodged Kosovo, the effects might be expected to arrive soon enough to disrupt this infant economy. It is suffering from typical economic problems all newly formed countries suffer – a huge trade deficit, chronic unemployment and a major reliance on remittances. Kosovo could become an example of a country upon which the crisis had the smallest direct impact, but due to a lack of investment incentives in the region it may bear unexpected consequences. The general conclusion Gashi draws is that although a low level of integration has been the main factor behind mitigating the crisis effects it can prove to be the biggest barrier to Kosovo’s future economic development.

Trajko Slaveski in chapter 10 notes that according to the IMF the crisis had a small impact on Macedonia due to a swiftly introduced set of macroeconomic policies (a fall in GDP of just 1%). Another good reason might be the fact that Macedonia experienced a slow transition that delayed growth until 2005. It didn’t, in the way of the other transitional economies, experience large capital inflows that might have spurred growth but brought trouble later on. It was spared from an excess property bubble and was able to avoid the crisis’ most severe consequences but this also helped them realize that the current model of the economy needs a change. Structural reforms (among the top 10 fastest reformers), a low level of public debt and sensible monetary policies (ensuring a stable banking system) enabled the economy to adapt to the crisis with limited adverse effects on the government’s fiscal position, enabling a fiscal stimulus without a corresponding high increase of the deficit. The government also engaged in tax cuts as another way to stimulate the economy, combining them with fiscal expansion to create an even better effect. However, Macedonia is not without problems. The recovery seems to be rather slow due to the unfavourable structure of its exports. The negotiations with the EU are at a stand-still due to the political dispute Macedonia is having with Greece, and there is growing concern that the impact of the Greek debt crisis
on Macedonia may trigger additional unfavourable effects. The current growth model for Macedonia came to an end with this recession, in much the same way it did for other SEE countries. Slaveski suggests that greater emphasis must be put on private capital inflows directed towards an increase of supply in the tradable goods sector and more efficient use of the EU pre-accession funds.

In chapter 11, Veselin Vukotić tries to explain the lack of optimism that struck the Montenegrin economy just around when the crisis struck. He starts his analysis even before Montenegrin independence, up until the post-crisis consequences. From the 1990s Montenegro started to develop its own new economic system based on the free market idea. This opened the economy to foreign investments, decreased tax rates, introduced the Deutsche Mark as legal tender (replaced by the euro in 2002), and enabled the protection of property rights and the enforcement of contracts. The reaction of this small open economy, especially after the 2006 independence was striking – the fastest growth in the region, substantially decreased unemployment and foreign debt, low, stable inflation and huge FDI inflows. The start of the crisis in 2008 influenced an economic stagnation from that point on. Another contributing factor was the abandoning of the previously set free market economic strategy in 2007, as the government put a stop to several privatization projects sending a negative signal to investors. Vukotić highlights the importance of will and courage as economic factors without which deeper structural problems will arise. Large public sector employment, a lower export capacity of the economy and a decline of high inflows of foreign investments increased the vulnerability of the Montenegro economy. The challenges facing Montenegro revolve around the issue of rethinking economic policy. Vukotić argues against increasing state interventionism as this is unlikely to help a small open economy. Montenegro should rather focus on how to reinstate a favourable environment for entrepreneurs and build its growth on the continuation of liberal economic policies with reduced influence of the state and future employment being more dependent on the private sector.

Romania experienced particularly strong effects of the crisis. Ileana Tache and Cristina Neesham cover this in chapter 12 and focus on pre-existing vulnerabilities that were exacerbated by the crisis, pointing out that Romania’s downturn is not all due to the global recession. They examine the negative effects of the pre-crisis growth model and how this affected the appreciation of domestic currency, increasing the country’s vulnerability. They offer an insightful causal relationship on how the macroeconomic effects of an inefficient growth model caused the country to be more vulnerable to external shocks. The irresponsible fiscal policy created additional pressures, as when the recession struck, Romania already had a budgetary crisis to handle. They argue that it would have been much easier for Romania if they had not had such a large public deficit. Domestic policies were the most responsible for the even stronger effect of the global recession on the Romanian economy, just as they were in the majority of the SEE countries. Tache
and Neesham expect a slow recovery, as they question the policymakers’ incentives to apply the needed economic policies. They suggest Romania should reduce interest rates, try to increase savings and above all ensure a sustainable fiscal position and public fund management (allocation based on efficiency). They also urge structural reforms (social security, education and R&D) in order for the country to remain competitive on the global market and catch up with the EU-15 level of income.

In chapter 13 Pavle Petrović starts with examining the pre-crisis economic imbalances in Serbia which were, as in other SEE countries, only deepened by the crisis. High growth rates led by large inflows of capital resulted in large external deficits implying overconsumption and overinvestment in Serbia. Petrović suggests that due to this overheating, the Serbian economy became more vulnerable to external shocks. During the onset of the crisis the inflow of foreign credit stopped, there was a rapid decline in exports causing a deep drop of aggregate demand and a rise in the unemployment rate. However due to the severe drop in imports and a large but well-managed depreciation of the currency Serbia experienced only a modest decrease of GDP, modest, at least, compared to other countries in the region. He draws an interesting comparison between Croatia and Serbia in this case saying that Croatia defended its currency much more strongly, allowing only for minor depreciation but at the same time experienced a much larger drop in output. Petrović further examines and evaluates the monetary and fiscal policy responses and points out how the decisive factor was prior support from the IMF that helped Serbia mitigate the full crisis effect somewhat successfully. This €3 billion standby arrangement combined with the Vienna Agreement prevented the collapse of the currency and backed the banking sector. Concerning fiscal policy, Petrović says that during the pre-crisis period, despite increasing revenues, the deficit was too large, leading to increasing vulnerability in times of crisis, when the revenues could be expected to drop. The Serbian government had to freeze public sector wages and pensions and cut expenditures so as not to increase the deficit too much, all in accordance with the IMF policies. However the deficits are still increasing, thus raising the public debt and providing a threat to Serbia’s sustainable recovery. In the medium run, Petrović suggests, Serbia should tackle the budget deficit and focus on boosting its competitiveness bringing about an export-led recovery. There is however a political danger that he recognizes; by increasing expenditures to capture votes, the forthcoming elections may extend the budget deficit even further.

The book is intellectually stimulating as it not only offers differing views on how to approach recovery, it also discusses the various interpretations of the main causes of the crisis. Although the authors agree that most of the countries experienced similar shocks and had similar pre-conditions leading up to a recession more severe than hoped for, they still differentiate in style, focus, solutions, and the explanations of the causes, meaning that their analyses are not perfectly com-
parable, either in offering solutions or in explaining the reasons behind the indirect crisis effects. The editors try to stay impartial providing freedom to the authors to express fully their own views in order to create an effect of diversity in the experiences of these somewhat similar countries.

From such an approach the reader might conclude that different countries require different measures and that it would be exciting to enter the debate on expansion vs. austerity in the Balkan case. The region is still mostly occupied with problems of transition and post-socialist institutionalisation. This book successfully diverges from this debate and introduces a new one – one that should become more present in everyday economic thinking of the SEE countries. If the book were to achieve only a slight contribution towards this enhancement of ideas, it would already present an improvement. Due to limitations of space, there is still relative unclarity in the opposing views of how the SEE countries should handle the situation. A better approach perhaps would be to introduce opposing but sensible solutions in each case and let the reader’s curiosity choose a standpoint from which his or her conclusions can be drawn. Although the book was probably designed with the idea that it was pioneering research on the crisis in this historically and culturally unique area, the editors, as well as their team of authors, should consider broadening the subject to bring about a much needed boost of economic knowledge in the SEE area, enabling it to reach a wider audience, the policymakers in particular.

If the insights from the book reached the policymakers instead of remaining only in the horizon of the academics, then it might just have the effect the editors and the authors were hoping for. If not, it will remain another excellent economic analysis of the pre- and post-crisis situation and great reading for anyone interested not only in how the crisis hit the SEE countries but also in their economic problems in general, and how to offer a proper solution to resolve these problems.