Comparative Analysis of South Eastern Europe Economies Facing the Crisis. Future Prospects for the Region

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***Abstract**:* *This paper analyses the effects of the global economic crisis in ten South Eastern European countries (Albania, Bulgaria, Bosnia and Herzegovina, Croatia, Greece, Kosovo, Macedonia, Montenegro, Romania and Serbia), within a European perspective. It also points out the main transmission channels of the economic crisis, by outlining the strong economic and financial ties with the EU, acting like contagion corridors in the event of global downturns. In terms of macroeconomic policy responses of the countries, these mainly led to increased fiscal deficits and public debts. Taking as benchmark the Romanian experience during the crisis, we outline several important structural reforms intended to boost competitiveness in the area. The paper concludes that, in spite of the recent negative evolutions, the SEE-10 region has an important economic potential for the future. In the final recommendations we explore the creativity potential of the region, as a strategic opportunity for putting the region on the global competitiveness map.*

Keywords: *South Eastern Europe, growth, economic crisis, competitiveness*

JEL classification: *O11, F15, F4*

1. Introduction

During the last ten years, South-Eastern Europe has been going through major transformations. The region has attained important progress in economic development, regional cooperation and integration in the global markets. However, the financial crisis that affected the western markets in the second half of 2007 made it clear that the region would face a major economic slump (Sanfey, 2010). The global economic crisis has also severely affected the European economies. After more than three years from the onset of the economic crisis, the efforts to mitigate the negative effects, to render public expenditure more efficient and to ensure sustainable economic growth have not vanished. Neither has the fear of a crisis revival worldwide.

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The European Union (EU) and the Economic and Monetary Union have been experiencing the most challenging period since their inception. The *Treaty on Stability, Coordination and Governance* has been recently signed by 25 EU members states (all with the exception of the United Kingdom and the Czech Republic) and will pave the way for more fiscal discipline in the euro area: the structural deficits will not be allowed to exceed 0.5% of GDP at market prices and public debts exceeding 60% of GDP will be reduced by an average of 1/20 per year.

Taking into consideration this difficult economic context and the changing rules at the European level, the integration of South Eastern Europe (SEE) requires further scrutiny. This region has also been negatively affected by the crisis. That is why the paper focuses on the economic experience of these countries during the recent economic crisis. More precisely, the study considers 10 countries in SEE (SEE-10): Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Greece, Kosovo, Macedonia, Montenegro, Romania and Serbia. Greece became an EU member state in 1981, while Romania and Bulgaria took the challenge in 2007.

Croatia, which has gone through major structural reforms, is going to join the EU in 2013. Montenegro, Macedonia and more recently Serbia have been granted candidate status to the EU. In the case of Montenegro, the European Council launched the accession process with a view to open accession negotiations in June 2012. The other countries, Albania, Bosnia and Herzegovina and Kosovo are considered potential candidates for EU accession (European Commission – Directorate General for Enlargement, 2012).

The EU membership represents a continuous race to improve the economic performance and to diminish the real convergence gap with the core countries of the Union. Furthermore, each country has to define its identity and its place in the EU, avoiding the complex of "fax democracy", which means that public policies are designed in the EU and then simply applied in the region. Indeed, the fact these countries are so many and small highlights the need for cooperation and for a regional axis that could act as a powerful voice able to make itself heard and able to balance the strength of larger Member States.

The region faces important common features, such as a history full of conflicts, multi-ethnic composition of their societies, low GDP per capita levels in comparison to the EU – 27 averages, and a strategic orientation towards the EU. The European integration is widely recognized as key strategy towards economic development in the region. However, these countries have to be prepared to respect the rules, even though they will probably not be euro area members from the beginning. For instance, Romania joined the *Euro Plus Pact* and the *Treaty on Stability, Coordination and Governance*, without being an EMU member.

In this paper, we offer a comparative analysis of the crisis effects on the SEE-10 countries. Section 2 presents the economic and political framework of the region from the fall of the iron curtain up until now. Section 3 explores the main contagion channels of the financial crisis in these countries, emphasizing the strong linkages with the EU. The next section describes the effects of the financial crisis in terms of economic growth rates, GDP, employment opportunities, foreign investments and credit ratings. Section 5 outlines the macroeconomic policy responses of the countries, as regards the evolution of fiscal deficits and public debts during the crisis. Section 6 emphasizes structural reforms needed to boost economic growth and competitiveness, based on the Romanian experience.

The final recommendations point to the reshaping of the economic growth model in the SEE-10, within the European integration perspective, and to a possible strategic positioning of the region in order to take advantage of the new creativity era.

2. Economic and political framework of the region

The fall of the iron curtain in 1989 has invalidated to a big extent the mentality of half a century, forcing us to rethink Europe as a whole (Wolff, 2000). The isolation of Eastern Europe led to the development of economic inequalities. This concept of Eastern Europe has served to define Western Europe as opposed to a poor and underdeveloped region. Throughout its history, the region has been known for conflicts, wars, dictatorships and poor development tracks (Bislimi, 2010).

Furthermore, starting from the early phases of transition to the market economy, two major challenges appeared in the region. The first one was the socio – economic collapse of the countries and the important waves of immigration that were created. The second one had to do with the disintegration of Yugoslavia and the implications it had for the constitutional name of the Former Yugoslav Republic of Macedonia (Monastiriotis and Tsamis, 2007).

After the wars in the 1990s, there has been a positive change in the perspectives of the region. The main reason for this was the hope for the European integration.

The last decade has changed the landscape for the SEE-10 region. There has been a major transformation of economic relations after the collapase of communism. The new economic space meant new opportunities in terms of resource exploitation, new markets and trade partners. It also gave the countries in the region the opportunity to explore the potential of the international competitiveness in a globalized world.

These developments required a holistic regional approach to the region from the EU in order to implement a coherent model for it. If multilateralism and regional integration would have been effectively promoted and implemented at that time, maybe the countries had not been in such a bad situation during the 1990s: the countries suffered from transition shocks that took a lot of time to recover and from tensions that led to the events in Bosnia and Kosovo (Monastiriotis and Tsamis, 2007).

The idea that there is a serious need for commitment from the EU in the region has become a common opinion among European policy-makers. Otherwise, the countries would have become more isolated from the neighbouring developments and they could have endangered the stability of the entire continent (Bărbulescu and Troncotă, 2012). The studies regarding the *Europeanisation* of the region have largely developed after 2000 at the same time with the emerging enlargement agenda of the EU. For the region, the core of the *Europeanisation* is represented by the creation of democratic institutions and a stable community.

The European perspective of the region has played a major role in defining the future path for the Balkans. However, accession to the EU does not represent a short or easy process. In fact, this is a long process which implies the implementation of reforms. The enlargement process comes along with conditionalities. The admission conditions, known as the Copenhagen criteria, listed the conditions that each country had to meet before they become members of the EU. More precisely, eligible countries for EU admission must have representative democratic institutions, market-based and competitive economies, must uphold the rule of law, protects minorities and their rights, respect human rights and must have the ability to meet the obligations of the EU (Bislimi, 2010).

It is clear that the future of the EU is interlinked with that of South Eastern Europe. It is in the self-interest of the EU to stabilise the SEE region and the debate regarding the enlargement process should not be considered in terms of cost of enlargement, but in terms of costs of non-enlargement (Kühne, 2010).

This is why the paper evaluates the economic developments in the SEE region during the crisis from a European perspective. Even though only three of them have become EU members, this work looks at the evolution of macroeconomic indicators during the recent crisis in comparison with the EU average for all SEE countries.

3. The main contagion channels of the financial crisis in the region

The strong economic relations of the SEE-10 countries with the EU represent both an evidence of their European orientation and a challenge during times of crisis. In fact, the global financial crisis acted as an important external shock for this region. Even though the banking system was not directly exposed to "toxic assets", the crisis has been transmitted through indirect channels (Bartlett and Monastiriotis, 2010). These included international trade, foreign direct investments, remittances from migrant workers and monetary policy. The banking system has also been affected through the presence of foreign banks in the region. However, it is noticeable that the contagion channels mattered differently for each country.

In terms of trade relations, the EU is the main export market for SEE-6[1] countries accounting for 58.2 percent of total exports, mainly to Italy and Germany (World Bank, 2011b). In this case, these strong relations are underpinned by Stabilization and Association Agreements with the EU. As regards the three EU members, Romania, Bulgaria and Greece, the shares are even higher: more than 70% of Romania's exports and imports are carried out within the EU; approximately 60% of the Bulgarian trade is within the EU; 62% of the Greek exports and 51% of the imports are within the EU.

Foreign direct investments (FDI) are largely provided by the EU in the region. Net FDI inflows are over 2 percent of the GDP in SEE-6 countries (World Bank, 2011b). Austria was the largest FDI provider to Montenegro from the EU in 2010. The main FDI providers to Romania are also EU countries: the Netherlands, Austria, Germany, France and Greece. Greece also benefited from strong investment coming from the EU during 2003 – 2010: Germany, France, UK, Belgium, Luxembourg and the Netherlands. It is quite clear that the financial crisis in the EU has led to a slump in the investments to the region.

The crisis has had a negative impact also on the level of remittances from people working in the EU.

The remittances of the Albanian diaspora, concentrated in Greece and Italy, decreased from EUR 838.4 mil. in 2008 to EUR 784.4 mil. in 2009. It is also the case of emigrants

[1] SEE-6 refers to Albania, Bosnia and Herzegovina, Kosovo, Macedonia, Montenegro and Serbia.

from Bosnia and Herzegovina that chose Croatia, Germany and Austria as top destination countries: workers' remittances decreased from EUR 1.299 bn. in 2008 to EUR 1.030 bn. in 2009. Workers' remittances to Greece decreased as well, from EUR 1.489 bn.in 2008 to EUR 1.157 bn. in 2009 (World Bank, 2011a).

The economic crisis has halved workers' remittances inflows to Romania, from EUR 5.156 bn. in 2008 to EUR 2.398 bn. in 2010. More than 80% of the remittances come from the EU, with Italy and Spain being the major remittance corridors for this country.

There are, however, also exceptions from this rule. It is the case of Serbia, where a large diaspora of workers is located in the USA and due to the measures taken to preserve employment, the remittances increased from EUR 1.99 bn. in 2008 to EUR 2.7 bn. in 2009 (World Bank, 2011a). Bulgaria also managed to increase the remittances during times of economic crisis, from EUR 694 mil. in 2008 to EUR 760 mil. in 2010, even though approximately two thirds of the inflows come from the EU (Eurostat, 2012).

As regards the banking system, its assets are held by the foreign banks in a proportion of 89% in the SEE-6 countries. The region has a comparatively high share of Greek- and Italian-owned banks. In Romania, 85% of the banks are owned by foreign capital. Taking into account the EU calls to increase banks' capital, this could put pressure on the local subsidiaries and could lead to a credit crunch in the region.

The monetary policies of these countries also represent an important transmission channel of the crisis in the region, because they are well-linked to the EU. Apart from Greece, which is a member of the euro area, many of these countries use the euro as reference or have adopted the euro currency. Macedonia has a managed currency using the euro as reference. The Macedonian central bank was faced with pressures on foreign exchange reserves and it increased the reference rate in the months following the crisis; Kosovo and Montenegro have unilaterally adopted the euro; Bosnia and Herzegovina has a euro-based currency board and Bulgaria's currency board is pegged to the euro, which puts pressure on the competitiveness of exports.

Romania, Albania and Serbia have flexible exchange rates. In the case of Romania, the National Bank has been reducing the monetary policy interest rate from 10.25% in 2008 to 5.50% in February 2012, in order to boost economic growth.

All these contagion channels have led to the transmission of the financial crisis in the region and caused the negative economic developments that we will further present in the next section.

4. The effects of the financial crisis in the region

Rapid credit growth has been one of the main drivers of growth in the region during the recent years and it has led to increased consumption. As a result of this rapid financial deepening, the ratio of domestic credit to GDP has reached relatively high levels in Montenegro, Croatia and Bosnia and Herzegovina. Credit to households had expanded by more than 130% on annual average in Montenegro during 2005-2007. The allocation of credits was in many cases biased towards consumption rather than productive or investment activities (European Commission, 2009).

The economies of the SEE region have been seriously affected by the global recession, in fact more than other regions in the world (Mitra et al., 2010). In 2009 both the EU-27 and the SEE-10 economic growth averages had recorded negative values. The decline marks an end to nearly a decade of accelerating growth in household incomes and employment.

However, while Romania and Croatia have been the most severly hit by the crisis in 2009, with negative growth rates of 6.6% and 6% respectively, Albania and Kosovo managed to keep positive growth rates that year (Table no. 1). This suggests that there are economies in the region that performed better than the EU.

Table no. 1 - GDP real growth rates (%), 2007 – 2012

Country	2007	2008	2009	2010*	2011**	2012**
Croatia	5.1	2.2	-6.0	-1.2	0.6	0.8
Macedonia	6.1	5	-0.9	1.8	3.1	1.8
Albania	6.0	7.7	3.3	3.5	1.8	1.2
Bosnia and Herzegovina	6.8	5.7	-3.1	0.8	1.8	0.5
Kosovo	6.3	6.9	2.9	4	5.3	5
Montenegro	10.7	6.9	-5.7	2.5	2	1.9
Serbia	5.4	3.8	-3.5	1	1.9	1.1
Romania	**6.3**	**7.3**	**-6.6**	**-1.6**	**2.5**	**1.6**
Bulgaria	6.4	6.2	-5.5	0.4	1.7	1.4
Greece	3	-0.2	-3.3	-3.5	-6.9	-4.4
Area average	**6.2**	**5.2**	**-2.8**	**0.8**	**1.4**	**1.1**
EU - 27 average	**3.2**	**0.3**	**-4.3**	**2**	**1.5**	**0**

* Estimations of World Bank.

Sources: World Bank Report, "South East Europe Regular Economic Report", November 2011, p. 1, Eurostat database for Romania, Bulgaria, Greece, EU – 27 average and Croatia.

** Data for 2011 and 2012 come from the European Bank for Reconstruction and Development, January 2012, with the exception of Romania, Bulgaria, Greece and Kosovo.

According to the estimates, the economic growth has resumed in 2011 and positive trends are also forecasted for 2012, with the notable exception of Greece. The average economic growth for this year amounts to 1.1%, more than the EU average equal to 0%. Romania ranks 4th in the region with a GDP increase of 1.6%. However, the growth rates are definitely lower than the pre-crisis levels and very dependent on the international and European evolutions.

The SEE-10 countries lag behind the EU living standards, as proxied by GDP per capita in each country compared to the EU average (adjusted for purchasing power) in 2010. Apart from Greece which has been an EU member for 31 years, among these countries only Croatia reached 61% of the EU average. In 2010, Romania ranked 3rd, after Croatia and Greece, in terms of GDP per capita as share of the EU average (Table no. 2).

Furthermore, the negative international outlook led also to a shift in the trend of real convergence with the EU in these countries. More exactly, more than half of the SEE-9 region (without Kosovo) recorded lower GDP per capita levels as share of the EU-27 average in 2010 as compared to 2008. Only Macedonia, Albania and Bosnia and Herzegovina managed to increase their share of GDP per capita in the EU average, while Bulgaria stagnated (Table no. 2).

Table no. 2 - Dynamics of the share of GDP per capita in the EU-27 average (PPS), 2008-2010

Country	2008	2009	2010	The effect of the financial crisis: 2010 level as compared to 2008 (p.p.)
Montenegro	43	41	41	**-2**
Croatia	64	64	61	**-3**
Macedonia	34	36	36	**2**
Albania	26	28	28	**2**
Bosnia and Herzegovina	30	31	31	**1**
Serbia	36	36	35	**-1**
Romania	47	47	46	**-1**
Bulgaria	44	44	44	**0**
Greece	92	94	90	**-2**
EU - 27 average	100	100	100	-

Source: Eurostat database, March 2012. We lack data for Kosovo.

Despite the negative effects of the recent crisis, these countries have an important growth potential on the medium and long term. The last three decades have seen an increase in GDP per capita of 94% in Bulgaria, followed by Albania (+85%). Romania's GDP per capita increased by 39% between 1980 and 2010. By comparison, China and India, which had significantly lower levels of GDP per capita than SEE-10 countries in 1980, increased by 1197% and 255% respectively, by 2010. Also Brazil's GDP per head increased by 34% during this period. Russia saw an increase of 36% in the last two decades (Table no. 3).

The SEE-10 countries could repeat the successful experience of the BRIC countries in the next decades if they manage to define their strategic position in this globalized world.

Table no. 3 – GDP per capita in USD, constant prices 2005, 1980 – 2010

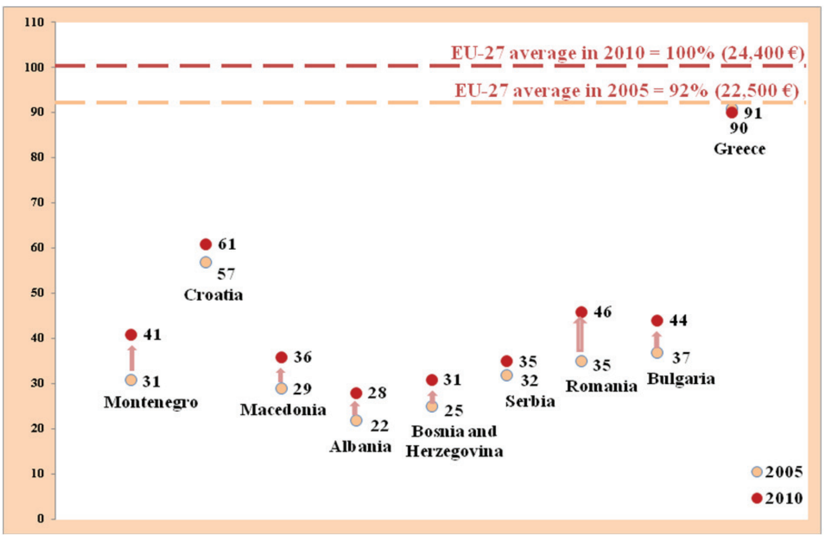
Country	1980	1990	2010	Dynamics 1980-2010
Albania	1,763	1,618	3,265	+85%
Bosnia and Herzegovina	-	530*	4,268	-
Bulgaria	2,284	2,915	4,419	**+94%**
Croatia	-	6,363*	10,619	-
Greece	15,272	15,520	21,944	+44%
Macedonia	-	2,526*	3,267	-
Romania	**3,752**	**3,829**	**5,210**	**+39%**
Brazil	4,205	3,999	5,629	+34%
China	229	477	2,965	**+1197%**

India	285	403	1,011	+255%
Russia	-	4,611*	6,293	-
World	4,988	5,707	7,466	**+50%**

*Data for 1992. Source: UNCTAD, March 2012.

Taking into account the European perspective of the countries that are not yet EU members, it is interesting to assess the progress made in the recent years with an emphasis on the effects of the crisis. From 2005 onwards, the SEE-10 countries have been slowly making progress towards the EU average levels of GDP per capita in PPS. The front-runner in the region has been Romania, with a speed of 11 percentage points (p.p.) in bridging the gaps with the EU during 2005-2010, followed by Montenegro with 10 p.p. However, except for Greece that recorded a negative evolution, Serbia seems to be the under-performer: its GDP per capita increased by only 3 p.p. (Chart no.1). This represents an important challenge for the countrie's future accession process to the EU.

Chart no. 1 - Dynamics of the share of GDP per capita in the EU-27 average (PPS), 2005-2010



Source: Authors' work based on Eurostat data. We lack data for Kosovo.

As we have seen before, the crisis had an important impact on the living standards of the countries. The social conditions of the people have also been strongly affected during the recent period of time. The number of unemployed workers and unemployment rates rose across the region and income poverty levels certainly increased, particularly for vulnerable groups.

The most recent evaluations state that the negative effects on the people are already noticeable: 75% of the households in Bulgaria and 72% of the households in Serbia have been significantly affected by the economic crisis. The least negatively affected were households in Croatia (only 55% of them). In Romania, 62% of the households have been affected by the crisis (EBRD, 2011).

As expected, the economic crisis led to a decrease in the level of employment both in the area and in the EU. The challenge is two-fold for the region: to reverse the declining trend in the employment opportunities and to fill the 14.4 percentage points gap with the EU. There are also countries that perform better than the SEE-10 area average: Romania, Croatia, Albania, Serbia, Bulgaria and Greece (Table no. 4).

The unemployment rates are generally well above the EU-27 average, with Kosovo displaying the highest unemployment rate, of 45.4%, in 2009. The area average was double than the EU-27 average in 2009. Only Romania and Bulgaria recorded unemployment rates below the EU average in the same year (Table no. 4).

As a concluding remark, labour participation and employment opportunities remain fairly low and unemployment rates in SEE-10 are in doublue-digit figures in most of the economies. Along with the improvement of skills and overall productivity, increased investment could contribute to employment creation, by accelerating growth and helping solve some of the social problems that the region is confronted with (European Commission, 2009).

Table no. 4- Employment and unemployment rates (%), 2006-2009

Country	Employment rates (%), 15-64 years				Unemployment rates (%)			
	2006	**2007**	**2008**	**2009**	**2006**	**2007**	**2008**	**2009**
Croatia	55.6	57.1	57.8	56.6	11.1	9.6	8.4	9.1
Macedonia	39.6	40.7	41.9	43.3	36	35	33.8	32.2
Albania	46.23	56.43	53.76	53.4	13.8	13.5	13	13.8
Bosnia and Herzegovina	35	36.8	40.7	40.1	31.1	29	23.4	24.1
Kosovo	28.7	26.2	24.1	26.1	44.9	43.6	47.5	45.4
Montenegro	41	49.2	50.8	48.7	29.6	19.3	16.8	19.1
Serbia	49.85	51.5	53.7	50.39	21	18.3	13.6	16.12
Romania	58.8	58.8	59	**58.6**	7.3	6.4	5.8	**6.9**
Bulgaria	58.6	61.7	64	62.6	9	6.9	5.6	6.8
Greece	61	61.4	61.9	61.2	8.9	8.3	7.7	9.5
Area average	47.4	49.9	50.8	**50.1**	21.3	19	17.6	**18.3**
EU - 27 average	64.4	65.3	65.8	**64.5**	8.3	7.2	7.1	**9**

Source: Eurostat, March 2012

Foreign direct investment (FDI) is important for capital formation, because it increases the capital stock and it leads to technological spill-overs. The literature on the relation between FDI and economic growth states that FDI effiency spill-overs exist and that FDI is positively correlated with growth (Lim, 2001).

However, FDI in the region was more than 3 times lower in 2011 than in 2008, because of the crisis. The investments resumed slightly in 2011 as compared to 2010, but remain under the high levels recorded in 2007-2009. In the years prior to the economic crisis, the foreign investment was concentrated in only a few sectors: the manufacturing and financial sectors, which were very vulnerable to the crisis. The banking sector of the SEE region has attracted substantial foreign investment and, as a consequence, in most economies foreign-ownership is above 80% (European Commission, 2009).

During 2008 - 2010, Romania was the leader in attracting FDI among the SEE-10 countries. In 2011, the highest level of FDI inflows was attracted by Serbia. In terms of FDI stock per capita at the end of 2010, the ranking changes: Montenegro recorded the highest level (6,480 euro), followed by Croatia (5,855 euro). Romania ranks 4th in the region, with 2,444 euro per capita (Table no. 5).

As regards the nationality of the investors in the region, the biggest part of foreign investments comes from neighbouring countries or from European countries with a regional approach to the SEE market. For example, Austrian banks have acquired local banks in all countries, except for Macedonia, and Deutsche Telecom (or its subsidiary Magyar Telecom) owns the incumbents in Croatia, Macedonia and Montenegro (European Commission, 2009).

In the case of Montenegro, the largest FDI inflows came from Russia (90.4 mil. euro), followed by Serbia (81.8 mil. euro) and Switzerland (64.7 mil. euro) in 2010 (Central Bank of Montenegro, 2011).

Table no. 5 - FDI inflows, 2007 – 2011

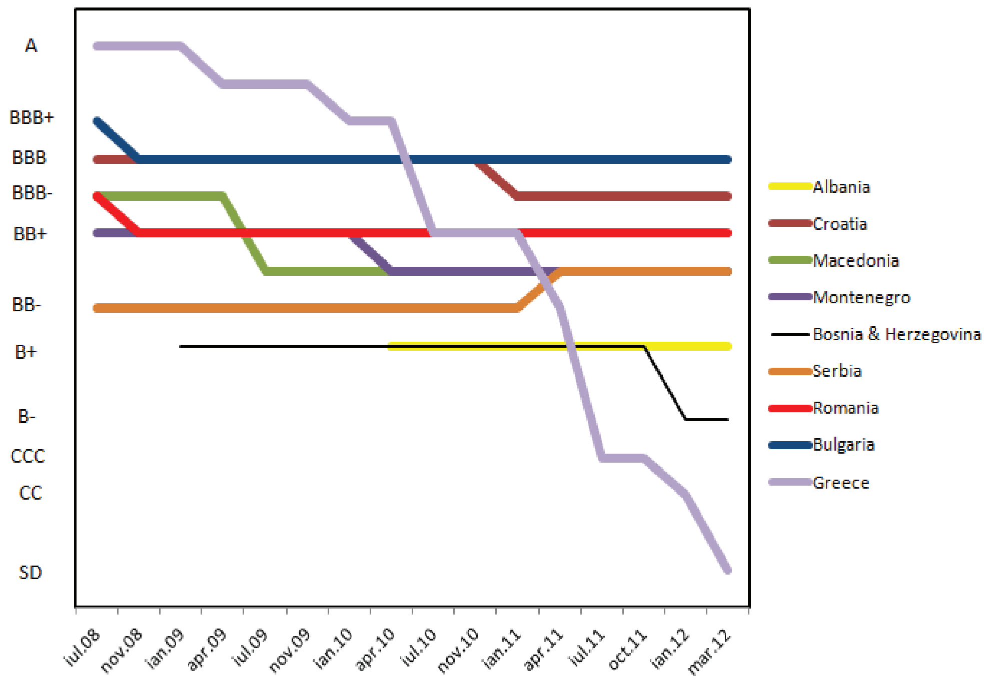
Country	**FDI inflows (bn. euro)**					**FDI stock/capita, 2010, euro**
	2007	**2008**	**2009**	**2010**	**2011**	
Albania	0.481	0.665	0.696	0.831	0.650	1,019
Bosnia and Herzegovina	1.52	0.684	0.18	0.174	0.250	1,427
Bulgaria	9.052	6.728	2.437	1.779	1.064	4,801
Croatia	3.651	4.219	2.38	0.281	1.20	5,855
Macedonia	0.506	0.4	0.145	0.159	0.210	1,636
Montenegro	0.683	0.656	1.099	0.574	0.300	**6,480**
Romania	7.25	9.5	3.49	**2.22**	**1.92**	**2,444**
Greece	1.54	3.07	1.75	0.281	**1.3**	2,245
Serbia	2.513	2.018	1.41	1.003	**2.0**	1,566
Total	**27.2**	**27.94**	**13.59**	**7.3**	**8.9**	**-**

Source: WIIW – Vienna Institute for International Economic Studies, National Banks and UNCTAD, March 2012. We lack data for Kosovo.

An acceleration of structural reforms on labour and product markets and the improvement of the public spending quality would increase the capacity of these economies to compete with other emerging markets in attracting foreign investment in the recovery phase (European Commission, 2009).

There is another important effect of the financial crisis in the region. The international conditions determined credit rating agencies to pay a lot of attention to the macroeconomic stability of the countries. The SEE-10 region has also been hit by credit ratings downgrades during 2008-2012 (Chart no. 2 and no. 3), which affect the costs of financing from the markets. Greece has been recently downgraded by Standard and Poor's (S&P) rating agency to selective default category in response to the country's decision to involve the private sector in its debt restructuring.

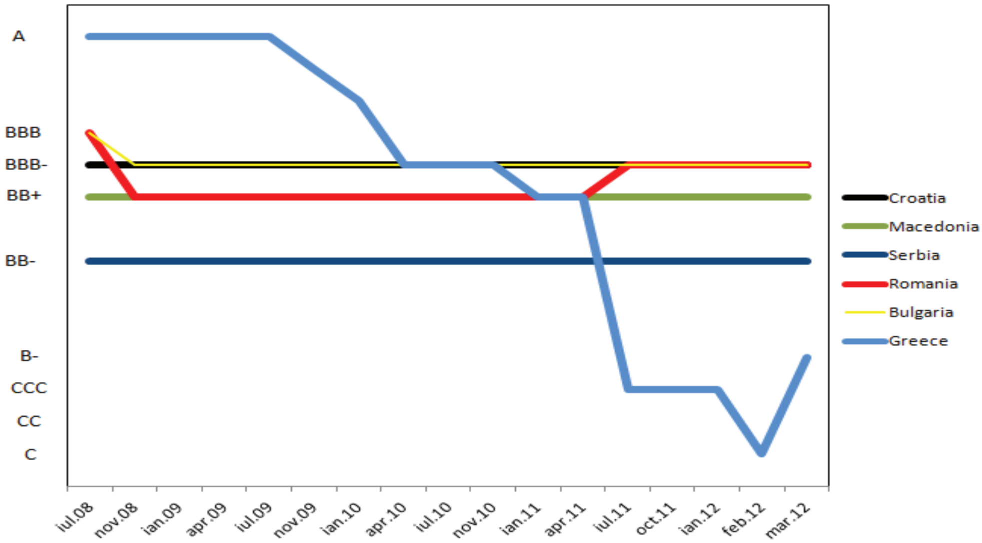
Chart no. 2 - Evolution of S&P sovereign ratings, 2008-2012



Source: Authors' work based on Bloomberg data, March 2012

Countries in the SEE-10 region have also been downgraded by the Fitch agency during the last four years, though to a lesser extent than S&P. The most noticeable negative evolution is that of Greece, whose rating was revised down from A in July 2008 to C in February 2012, followed by a surprising increase to "B-". The decision came as a consequence of the debt writedown in a bond swap with private creditors.

Chart no. 3 - Evolution of Fitch sovereign ratings, 2008-2012



Source: Authors' work based on Bloomberg data, March 2012

According to S&P, at the moment only Bulgaria and Croatia are included in the investment grade category among the countries in the region. Romania's rating has been stable since November 2008. Greece holds the lowest credit rating: selective default. Fitch agency rates Romania also in the investment grade category together with Croatia and Bulgaria. In the case of Romania, the rating was revised up in July 2011. Macedonia, Serbia and Greece are rated below this category by Fitch (Table no. 6).

Table no. 6 - S&P and Fitch sovereign ratings as of March 2012

Country	Long-term sovereign foreign currency rating by S&P	Long-term sovereign foreign currency rating by Fitch
Albania	B+	-
Croatia	BBB-	BBB-
Macedonia	BB	BB+
Montenegro	BB	-
Bosnia and Herzegovina	B	-
Serbia	BB	BB-
Romania	**BB+**	**BBB-**
Bulgaria	BBB	BBB-
Greece	SD (Selective default)	B-

Source: S&P and Bloomberg, March 2012

5. The macroeconomic policy responses of the region

All SEE-10 countries have experienced growing fiscal deficits in response to the financial crisis. They have exhausted their modest fiscal buffers created in the pre-crisis period, which make it difficult to resist in the case of worsening global conditions. If in 2007 Bosnia and Herzegovina, Kosovo, Macedonia, Montenegro and Bulgaria recorded a fiscal surplus, in 2009 and 2010 all the countries in the region were recording deficits. The average budgetary deficit in the area reached a peak of 5.78% of GDP in 2009 and decreased to 4.72% of GDP in 2010 (Table no. 7).

Romania applied severe austerity measures in order to reduce the budgetary deficit. Two-thirds of the Government's efforts to reduce the budgetary deficit focused on improving and reducing public expenditure and one third on increasing the revenues. Consequently, after the 7.3% fiscal deficit in 2009, 6.9% in 2010 and 4.35% in 2011, it is heading for a 3% fiscal deficit in 2012.

Table no. 7 - Budgetary deficit (% GDP), 2007-2011

Country	2007	2008	2009	2010	2011
Albania	-3.7	-5.5	-7.1	-3	-
Bosnia and Herzegovina	0.6	-3.5	-5.6	-4.2	-
Kosovo	7.3	-0.2	-0.7	-2.7	-
Macedonia	0.6	-0.9	-2.7	-2.5	-
Montenegro	6.7	-0.4	-5.7	-4.9	-
Serbia	-1.9	-2.7	-4.5	-4.6	-
Average SEE-6	**-0.5**	**-2.7**	**-4.6**	**-3.8**	**-**
Croatia	-2.5	-1.4	-4.1	-	-
Romania	**-2.6**	**-5.7**	**-7.3**	**-6.9**	**-4.35**
Bulgaria	1.2	1.7	-4.3	-3.1	-2.5
Greece	-6.5	-9.8	-15.8	-10.6	-8.9
Area average	**-0.08**	**-2.84**	**-5.78**	**-4.72**	**-**

Source: World Bank Report, "South East Europe Regular Economic Report", November 2011, p. 20; Eurostat data for Greece, Bulgaria and Croatia; national data for Romania; European Commission for 2011 data

Despite the increases in public debt generated by the fiscal expansions, all the SEE-10 countries, with the exception of Greece, continue to report public debt levels that are below the 60% of GDP reference point in the EU's Stability and Growth Pact. This is partly due to large privatizations conducted prior to the crisis. This way, the current account deficits of the region have been financed by FDI inflows and not by external debts.

However, there have been important increases of government debt to GDP ratios during the crisis. In 2009 Croatia had the highest level of public debt in GDP (35.3% GDP, data not available for Albania), followed by Serbia (31.3% GDP). Romania's government debt in GDP increased from 13.4% of GDP in 2008 to 31% of GDP in 2010 (Table no. 8). Within the EU, Romania had the 4th lowest public debt in the EU, as share of GDP both in 2010 and 2011 (31% of GDP in 2010, 34% of GDP in 2011).

Table no. 8 - General government gross debt (% GDP), 2000-2010

Country	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Croatia	-	40.1	40	40.9	43.2	38.3	35.5	32.9	28.94	35.3	-
Macedonia	47.92	48.8	42.89	38.96	36.6	39.54	32.93	24.73	21.32	24.07	-
Albania	60.17	58.5	63.92	61.53	58.33	56.83	56.77	54.83	53.89	-	-
Bosnia and Herzegovina	34.7	35.18	31.04	27.67	25.54	25.33	21.15	18.2	17.17	21.81	-
Serbia	-	104.8	71.9	63.3	50.7	50.5	39.8	30	25.3	31.3	-
Romania	22.5	25.7	24.9	21.5	18.7	15.8	12.4	12.8	13.4	**23.6**	**31**
Bulgaria	72.5	66	52.4	44.4	37	27.5	21.6	17.2	13.7	14.6	16.3
Greece	103.4	103.7	101.7	97.4	98.6	100	106.1	107.4	113	129.3	**144.9**
Area average	**56.87**	**60.35**	**53.59**	**49.46**	**46.08**	**44.23**	**40.78**	**37.26**	**35.84**	**40**	-
EU-27 average	61.9	61	60.4	61.9	62.3	62.8	61.5	59	62.5	74.7	**80.1**

Source: Eurostat, March 2012. We lack data for Kosovo.

Most SEE-10 countries have adopted some sort of regulation limiting the level of public debt. The commitment of the authorities to these targets is yet to be tested. Albania, Kosovo and Serbia have capped government debt through legislation, while Macedonia and Montenegro have done it through strategy-level documents (World Bank, 2011b).

Bulgaria currently debates the issue of incorporating the EU budget deficit rule in the Constitution. In Romania, constitutional limitation of public debt and budgetary deficit is subject to analysis given that it signed the *Treaty on Stability, Coordination and Governance* in EMU.

As regards the external financing of the countries in the region, the levels of gross external debts increased during 2008 and 2011, in line with the need to finance fiscal deficits in order to smooth out the effects of the crisis. Macedonia's gross external debt increased significantly by 39%, between December 2008 and September 2011. During the same period of time, the gross external debt of Romania increased by 35.3% (Table no. 9). However, Romania had the 10th lowest gross external debt in the EU-27 in September 2011.

Bulgaria has been the best performer, as it recorded a decrease of the gross external debt during a period of economic crisis.

Table no. 9 - Gross external debt, bn. euro, Dec. 2008 – Sept. 2011

Country	Dec. 2008	September 2011	Growth (%), Dec. 2008 – Sept. 2011
Albania	3.2	4.16	+30%
Bulgaria	37.2	36.26	-2.5%
Croatia	40.6	46.6	+14.8%
Greece	364.4	405.04	+11.2%
Macedonia	3.3	4.6	+39%
Romania	**72.35**	**97.9**	**+35.3%**
Serbia	21.0	23.86	+13.6%

Source: National Banks

When reported per inhabitant, Romania recorded the 4th lowest gross external debt per inhabitant among the countries in the region in September 2011 (Table no. 10). Romania had the lowest external debt per inhabitant among the EU countries, in September 2011: 4,570 euro/inhab. as compared to 4,810 euro/inhab. in Bulgaria or 7,002 euro/inhab. in Poland.

Table no. 10 - Gross external debt per inhabitant, September 2011

Country	Gross external debt (bn. euro)	Population (mil. pers.)	Gross external debt / inhab. (thousand euro)
Albania	4.16	3.0	1.39
Bulgaria	36.26	7.5	4.83
Croatia	46.6	4.4	10.59
Greece	405.04	11.3	35.84
Macedonia	4.6	2.06	2.23
Romania	**97.9**	**21.4**	**4.57**
Serbia	23.86	7.3	3.27

Source: National Banks and Eurostat database

6. Reform priorities for South Eastern Europe economies. The Romanian experience

The economic development of the SEE-10 countries depends both on evolutions at the international and European level and on structural reforms required to boost growth and competitiveness.

In the case of Romania, it has made important steps to increase its competitiveness in times of severe recession. Despite the resistance to change, it has opened 11 battle fields of reforms, namely: the fiscal framework, the public administration, the public sector employees' payment, the internal administration, the public pension system, the labour legislation, the social dialogue, the health system, the social assistance, the legal system, the education system.[2]

The need to limit the increase of the budgetary deficit and of the public debt required difficult, but necessary austerity measures that were applied in 2010. Some of these measures were: the 25% wage reduction in the public sector, freeze of the pension point, increase of the retirement age, layoffs in the public sectors (202,690 people have been dismissed between 2008 and 2012), elimination of the meal and gift vouchers and the VAT increase from 19% to 24%.

The economic evolutions have been positive and Romania recorded four consecutive quarters of economic growth. In 2011, GDP growth was 2.5%, the 10th highest in the EU, and exports have reached the highest level in the last 22 years in 2011 (45 bn. euro).

The economic crisis has made the need for structural reforms more pressing than ever in the region. There are several reform priorities to be addressed (World Bank, 2011b), already implemented by Romania:

a. Macroeconomic management – the introduction of fiscal consolidation plans; the reinforcing of tax compliance; the broadening of the tax base; strengthening of the supervisory authorities in the financial sector.

• **Business environment reforms –** shorten registration procedures; complete privatization programs; address the non-payment culture.

b. The Romanian experience:

- Diminishing the fiscal and administrative burden:
- 237 non-fiscal taxes and tariffs out of 491 were reduced or unified;
- Fiscal statements have been unified and can be submitted online;
- Establishment of a One-Stop Shop (http://www.immoss.ro/);
- Reduction of the period necessary to set up a company from 14 to 3 days.

- Financial support for the business environment:
- Governmental programs for supporting entrepreneurship. Outcome: more than 1,500 SMEs received financing from 2011 up to present;
- Guarantee schemes and state aids: EUR 1.35 bn. guarantees for supporting credits to SMEs during 2009-2011 and EUR 229 mil. state aids for 19 large investment projects during 2009-2011.

b. Social sectors – address demographic challenges in pension reforms; accelerate reform in health and social protection.

• **The Romanian experience**:

- Pension system: gradual increase of the retirement age to 65 years of age for men and to 63 for women by 2030; enforcement of the contributiveness principle in the public pension system.

- Health system: decentralization of the health care system (370 public hospitals out of 435 were transferred to the local public authorities) and the introduction of a clawback tax.

[2] For further information, please visit http://www.romtradeinvest.ro/images/stories/brosura%20guvern/Reforms%20 2009-2012%20-%2031%20ian%202012.pdf.

- Social protection: resizing the social protection measures only for the genuinely vulnerable categories.

d. Labour market rigidities and skill mismatches – implementation of a more flexible labour legislation; vocational training; life-long learning and tertiary education sector reform.

• **The Romanian experience**:

- Implementation of a new Labour Code: hiring and firing practices are more flexible; employers can conclude limited duration employment contracts of maximum 36 months, as compared to 24 months before; they can reduce the working hours or can fire more easily their employees during difficult economic conditions for their business.

- Implementation of the new National Education Law: defining a system based on the formation of skills, implementing the principle of financing per student and redefining the National Curricula according to the labour market needs.

e. Trade and service liberalization – liberalization of network industries (e.g. logistics, energy), privatization of state owned companies (SOEs) and removal of non-tariff barriers. Trade liberalization in the region advanced due to World Trade Organization (WTO), Central European Free Trade Agreement (CEFTA) membership and Stabilization and Association Agreements with the EU.

• **The Romanian experience**:

- Natural gas price liberalization – starting with 1 July 2011, the price of natural gas for the industrial consumers was increased by 10%.

- Establishment of priorities in the privatization of the state companies (e.g. Petrom, Transelectrica, Hidroelectrica, etc.).

- Restructuring of the state-owned enterprises: prevention of new arrears and losses and improved governance.

f. Governance reforms – acceleration of judicial and anti-corruption reforms; ensuring integrity and transparency in the public administration.

• **The Romanian experience**:

- Implementation of the National Anti-Corruption Strategy 2011-2014 based on three main pillars: prevention, education and control.

- Transparent financing of the political parties, electoral campaigns and public procurements.
- Enforcement of Anti-Corruption National Department (DNA) and National Agency for Integrity (ANI) as main pillars in the fight against corruption.

As regards the last point, all the SEE-10 countries are deeply involved in the race to reduce the corruption perception. According to the Heritage Foundation index of freedom from corruption, the area average increased by 11.56 points in the last 10 years. Montenegro has made the most important progress (+27 points), closely followed by Serbia (+25 points). The least successful country has been Bulgaria, with an increase of just 1 point in the index of freedom from corruption. Romania is better placed than Bulgaria, with an increase of 8 points in this period. Only Greece has taken substantial steps back (-14 points) (Table no. 11).

In 2012, the countries with the highest index of freedom from corruption in the region are Croatia and Macedonia. Romania ranks 3rd in the region, sharing its position with Montenegro.

Table no. 11 - Index of freedom from corruption, 2002 – 2012

Country	2002	2003	2009	2010	2011	2012	Difference 2012-2002 (points)
Albania	10	10	29	34	32	33	23
Bosnia and Herzegovina	10	10	33	32	30	32	22
Bulgaria	35	39	41	36	38	36	**1**
Croatia	37	39	41	44	41	41	4
Macedonia	33	33	33	36	38	41	8
Montenegro	10	10	33	34	39	37	**27**
Romania	29	28	37	38	38	37	**8**
Greece	49	42	46	47	38	35	**-14**
Serbia	10	10	34	34	35	35	**25**
Area average	24.78	24.56	36.33	37.22	36.56	36.33	**11.56**

Source: Heritage Foundation, March 2012

Overall, the Romanian experience could serve as a relevant example of structural reforms undertaken during the crisis for the countries in the region. However, the most important issue the region should focus on is the competitiveness deficit it has at European and international level now and in the post-crisis period.

The average competitiveness score of the area increased from 3.9 in 2008 to 4.1 in 2011, but the average ranking remained the same. There has been a general upward trend of the competitiveness scores in these countries in 2011 as compared to 2008, with the exception of Greece and Croatia (Table no. 12).

In the most recent Global Competitiveness Report 2011 – 2012, Romania ranks 77th in the world and 4th in the region, after Montenegro – 1st, Bulgaria – 2nd and Croatia – 3rd.

Table no. 12 - Global competitiveness index (GCI), 2008-2012

Country	GCI 2011-2012		GCI 2010-2011		GCI 2009-2010		GCI 2008-2009	
	Rank	Score	Rank	Score	Rank	Score	Rank	Score
Albania	78	4.1	88	3.9	96	3.7	108	3.6
Bosnia and Herzegovina	100	3.9	102	3.7	109	3.5	107	3.6
Bulgaria	74	4.2	71	4.1	76	4	76	4
Croatia	76	4.1	77	4	72	4	61	4.2
Macedonia	79	4.1	79	4	84	3.9	89	3.9
Montenegro	60	4.3	49	4.4	62	4.2	65	4.1
Romania	**77**	4.1	67	4.2	64	4.1	68	4.1
Greece	90	3.9	83	4	71	4	67	4.1

Serbia	95	3.9	96	3.8	93	3.8	85	3.9
Area average	**81**	**4.1**	**79**	**4.0**	**81**	**3.9**	**81**	**3.9**

Source: World Economic Forum, Global Competitiveness Reports

However, in order to compete with other fast growing economies and to reach the EU living standards, these countries need national competitiveness strategies on the long term. Romania has already set up the National Competitiveness Council (CoNaCo) in October 2011, a governmental *think-thank*, whose main goals are to define its strategic interest and to elaborate the National Competitiveness Strategy 2020. So far, CoNaCo has adopted the competitiveness declaration stating that Romania can become '*Europe's creativity heart'* and that Romania has the potential to be within the first seven competitive economies in Europe. Romania has a huge potential to develop the creative industries sector, due to their economic power: they make up 7% of GDP, one quarter of the companies activate in these industries and almost 2 out of 10 employees work in this sector. Croatia, Serbia and Macedonia have also established Competitiveness Councils to draft proposals for increasing their economies' competitiveness.

Studies regarding the emerging creative industries in South Eastern Europe have been developing since the beginning of the 2000s'. The official definition of the term states that creative industries are those industries which have their origin in individual creativity, skill and talent and which have a potential for wealth and job creation through the generation and exploitation of intellectual property (UK Department of Culture, Media and Sport, 2005). They range from software, architecture, design, game industries, film or advertising, to any form of art.

These industries stem from the tradition of industrial and market-oriented cultural production unfortunately undermined during times of socialism (Institute for International Relations in Zagreb, 2005). Redefining cultural identity for this region is both socially and economically reasonable. However, such a project would need the support of regional and intra-regional cooperation in order to succeed. By promoting creative industries as major development strategy in the region, the countries in South Eastern Europe would mix talent with tolerance and multiculturalism in a sector in which young people prevail.

7. Final recommendations

As we have seen in the paper, the recent financial crisis had significant negative effects on the South Eastern Europe economies. The contagion channels have enabled the transmission of the shocks to every country, although not evenly. The most affected countries by the crisis were Romania and Croatia, which recorded very serious decreases in GDP in 2009. However, according to the forecasts, their economic growth rates are positive in 2011 and 2012. In fact, the average growth of the whole region is back on a positive trend.

The macroeconomic policy responses led to important increases in the fiscal deficits, the highest level in the region being reached by Greece in 2009. However, the budgetary deficits are on a decreasing path, the best performers being Albania, Kosovo and Macedonia which respect the budgetary deficit criterion included in the Maastricht

Treaty. Romania is also heading for a 3% fiscal deficit in 2012. In terms of gross debts, all SEE-10 countries, apart from Greece, managed to maintain relatively low levels of public debts, below the 60% ceiling imposed by the Maastricht Treaty.

In order to boost economic development in the post-crisis period, there is an urgent need for structural reforms in the region and for measures to increase competitiveness. Overall, the growth model developed by these countries, which relies on a deeper integration with the EU remains the first – best option on the long term. However, in order to fully exploit the benefits, growth needs to be driven more by investment, productivity and competitiveness, and less by the capital inflows in the next decade.

Countries in South Eastern Europe should explore the potential of creativity as a new, major driver of competitiveness in the new economic era. At the EU level, the development of creative industries is one of the five priorities of the next financial period 2014 – 2020. These industries might drive South Eastern Europe countries on an accelerated growth map. They would make up a Creativity Club, within which Romania could act as a regional axis, ensuring stability and prosperity to the region.

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