European debt crisis threatens Balkan economies

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The deepening European financial crisis and the ever-growing possibility of bankruptcy for countries like Greece and Italy pose huge dangers for the economies of the Balkan countries. The latter are highly dependent on foreign capital investment and are intertwined with the economies of both Greece and Italy.

A number of recently published reports point to the graveness of the situation facing the so-called Western Balkan countries, a region that has never recovered from the decline of living standards in the 1980s, before the forcible reintroduction of capitalism and semi-criminal fire-sale of state owned assets crippled their economies.

While the region has seen comparatively high growth of 5-10 percent per year prior to the 2008 crisis, this growth relied heavily on foreign direct investment (FDI) or various aid projects financed from abroad. When investment dried up following the 2008 crises, most of the region experienced significant "negative growth" in 2009, with Montenegro, Serbia, Bosnia and Herzegovina suffering sharp recession.

The Balkan states recorded anemic average growth rates of only 1.6 percent in 2010, with similarly low projections for 2011 and 2012. However, even these low predictions may be unrealistically optimistic, according to the World Bank (WB) report on the region released last Tuesday.

Looking at six South-East European countries of Albania, Bosnia and Herzegovina, Kosovo, Macedonia, Montenegro and Serbia, dubbed SEE6, the WB warns at the beginning of its report that they "depend critically on factors that are largely beyond the control of their governments. They are influenced by the global slowdown and uncertainties in the Euro zone (EZ)."

The report terms the current growth rate as "sluggish" and states, "even these modest growth projections assume that the current turmoil in the EZ is resolved in a manner that doesn't involve a disorderly default and avoids contagion effects." Based on recent developments in the EU, this is wishful thinking.

The report continues by noting that the non-EU Balkan countries are "susceptible to the effects of a further global slowdown and a deepening euro area crisis through several channels: trade, FDI, foreign banks, and remittances. The EU countries … are the largest trade partners of all the SEE6: trade with the EU is equivalent to between 30 percent and almost half of the SEE6 GDPs."

Serbia, for example, would be most directly affected by the deepening crisis in Italy, because Italian companies, most notably the automobile company Fiat and the clothing manufacturer Benetton, are among the biggest investors in Serbia. Italy is the top export partner for Serbian products, with proceeds amounting to just over $1 billion in 2011, according to Goran Nikolic, economist from the New Policy Centre, reported by Balkan Insight.

The EU is also the largest FDI provider to the region, with net FDI inflows worth over 2 percent of the SEE6 GDP, and a significant source of remittances in the region.

Another major financial danger is the domination of foreign-owned banks in the region. The WB report explains that even though the banking system in the region "appears resilient... [t]his could change abruptly due to a high share of Greek and Italian owned banks in local banking systems. [N]ot only is the share of foreign banks in the total assets of the region's banking system very large (at around 89 percent of the total), but this foreign presence is largely an EZ one."

In a clear sign that the governments are aware and apprehensive of the ever more real prospect of state default in the EU, Albania's parliament introduced a new bill earlier this month aimed at forcing foreign banks controlling 95 percent of the country's market to transform their local branches into subsidiaries. The government is thus trying to protect depositors from a possible default of the mother institution.

The International Monetary Fund (IMF) has also noted the danger of a contagion effect of the EZ debt crises on Albania. Its October report candidly explains that the country "has large trade, labour-market, and banking-system links with Greece and Italy, which could result in substantial spillovers with banking-system contagion potentially the most severe near-term risk, while sharply lower remittances could result in a significant GDP shock".

The situation is similar in Montenegro. The November 2 edition of *The Balkan Insight* reported that the Finance Minister Milorad Katnic and World Bank Regional Coordinator for Southeast Europe Jane Armitage, presented the WB's report on public spending in Montenegro. The report declared that the country must reduce its fiscal deficit and public debt and reduce its dependency on foreign finance, "in particular at a time when conditions on the international market are sensitive and unpredictable" (emphasis added.).

Some two weeks later, on November 17, the local daily *Vijesti* carried a report from the Montenegrin Finance Ministry, which stated that the IMF could "in case of serious disturbances in the market and a major crisis" provide Montenegro with an unspecified financial loan.

It is evident that the IMF, WB and other representatives of financial capital are seriously considering the possibility of state default in the EU and are developing contingency plans aimed to transfer the fallout of a catastrophic crisis onto the working class of each country.

The capital flight from the region is already evident in currency exchanges. Last week's Financial Times article "Eastern Europe's currencies take a Eurozone beating" states that "[f]ar from benefiting from being outside the Eurozone, eastern European countries are feeling the strain of exclusion from the club" with "the value of their currencies plummeting."

Considering this a somewhat belated reaction the article continues: "Many analysts are surprised it has taken the foreign currency market so long to work out that the impact of the Eurozone crisis on the region's close trading partners in eastern Europe was likely to be severe." The Serbian dinar, for example, has lost almost 25 percent of its value in the last three years.

A renewed credit crunch in the Balkan region would be much more severe than in 2008-2009. The extent of social cuts and privatisation of state assets already carried out means that this time round there would be no room for softening the blow with further public spending cuts. This is the conclusion reached by the WB's chief economist for poverty reduction and economic management in Europe and Central Asia, Ron Hood.