

## Global Financial Crisis and Economic Sustainability in South East Europe

**Nurdan ASLAN**

Department of Economics, University of Marmara, Turkey  
[nuraslan@marmara.edu.tr](mailto:nuraslan@marmara.edu.tr)

**Nuray TERZI**

Department of Economics, University of Marmara, Turkey  
[nurayterzi@marmara.edu.tr](mailto:nurayterzi@marmara.edu.tr)

**Abstract:** The global financial system has witnessed rapid growth and substantial structural change during the last ten years leading to globalization of financial markets. The integration of financial markets has accentuated the rapid flow of capital across borders as well as magnified the contagious effects of financial crisis with wide implications for transmission of financial policies on the domestic economy and internationally. The global financial crisis has become a major international event and has spread to developing countries through trade linkages, a reduction of FDI and remittances, and a collapse in commodity prices. The effect of the global financial crisis was worsened by rising global energy prices which pushed up inflation. The global financial crisis has evolved differently from other major crises that have hit the developing world. This paper analyzes the economic sustainability in South East Europe against global financial crisis.

**Keywords:** global financial crisis, economic sustainability

### Introduction

From 2002 until the end of 2007 world economic growth averaged 4.5 per cent per annum compared to 3 per cent in the 1990s. Growth has been particularly strong and broad-based in the developing world, reaching some 7.5 per cent, twice the rate of the 1990s. Real commodity prices rose to levels not seen since the 1970s and developing countries as a whole started to run trade surpluses with advanced countries private capital flows to developing countries recovered strongly and spreads on emerging-market debt fell to historical lows. Price stability in the developing world has been unprecedented for many decades, with single-digit inflation rates being the rule rather than the exception (Akyuz, 2008).

As a result of continued deregulation of financial markets and further opening of national borders to international capital flows, economic activity in both advanced and developing countries has come to be increasingly shaped by financial factors. Low interest rates in some other advanced countries, notably in Japan, encouraged cross-currency flows towards countries with higher interest rates, including in the form of highly leveraged carry trades. The very same factors have played a major role in the strong recovery of capital flows to emerging markets, contributing to currency appreciations, asset bubbles and credit expansion, and stimulating spending and growth in the recipient countries (Akyuz, 2008).

In recent decades, world trade has shown two important characteristics. First of all, it has tended to expand more rapidly than world production, a process that has been accompanied 2008 by a rapid diversification in the trade structure. Thus, during the recent boom, in 2003-2006, world trade grew at an annual rate of 9.3%, more than twice the rate of growth of world output (3.8%). Second, these rates of growth have been highly elastic to world output through the business cycle and have, therefore, been more volatile than world production (UNDP, 2009).

These conditions have been replaced since mid-2008, particularly since September 2008, by the effects of financial turmoil that erupted in mid-2007 in the U.S. which has now become the worst global financial crisis and the worst recession since the Great Depression (UNDP, 2009). This financial crisis quickly spread to emerging market and developing economies. Investors have pulled capital from countries, even those with small levels of perceived risk, and caused values of stocks and domestic currencies to plunge. Also, slumping exports and commodity prices have added to the woes, pushing economies world wide either into recession or into a period of slow economic growth (Nanto, 2009).

The current financial crisis has imposed a heavy economic burden on many countries and significantly increased the incidence of poverty and vulnerability. This paper analyzes the economic sustainability in South East Europe against global financial crisis. The following section gives the channels of transmission of the crisis

to developing countries. Third section presents the economic conditions in South East Europe economies. Last section provides a conclusion.

## **The Channels of Transmission of the Crisis to Developing Countries**

The current economic and financial crisis was driven by the reversal of the three positive shocks that developing countries experienced during the recent boom period: exceptional financing, high commodity prices and large flows of remittances. The initial trigger that contributed to the reversals of these trends was the impact of the bursting of the U.S. housing bubble. The emerging recession in the United States and other developed countries further multiplied the negative impact of the crisis for developing countries (UNDP, 2009).

The one of the main channel of transmission of the crisis to exporters of manufactures and services is a decline in trade volumes and exporters of primary goods can be affected by declining prices. Falling energy prices can benefit energy importing countries but they can also lead to reduced investment and economic activity in commodity-dependent developing countries (UNDP, 2009).

The deterioration in financing conditions has been most severe for countries with large current account deficits. These countries showed signs of overheating and unsustainably rapid credit growth prior to the intensification of the financial crisis. About half of all developing countries have been running current account deficits of 5 percent of GDP or more, and in some cases the deficits are around 10 percent. Developing countries will be highly vulnerable to swings in various sources in external financing in coming years (Lin,2008).

The second channel for transmission of the crisis from developed to developing countries is via capital flows. The effects take place both through volumes and associated costs of such flows (UNDP, 2009). According to World Bank, private capital flows to developing countries are likely to fall significantly in 2009, led by pull-backs in portfolio flows and international bank lending. Large portfolio and foreign bank lending flows have contributed to rapid growth in credit to the private sector and large private-sector driven current account deficits in a number of countries. The sudden deceleration of inflows will force a sharp adjustment in private-sector activity. There is a high probability of balance sheet deterioration and possible banking crises where banks and non-bank financial institutions have expanded credit to the private sector most rapidly. There may be an especially direct channel in economies where there has been substantial borrowing from foreign banks, either through branches in the domestic market or through borrowing by local banks. Central and Eastern European economies, which have experienced especially rapid credit increases, with foreign banks playing a dominant role in the domestic market, could be most at risk (World Bank, 2008).

In addition, the current global financial crisis influences firms' capacity to invest as a result of reduced availability of finance and their propensity to invest due to gloomy economic and markets prospects. Financial factors have negatively affected TNCs' capacity to invest, both internally and externally, as tighter credit conditions and lower corporate profits curtail TNCs' financial resources for overseas investment projects. On the one hand, credit has become less abundant and more expensive. The gloomy evolution of markets, including the looming sharp economic recession worldwide and a heightened appreciation of risk, has also reduced firms' propensity to invest for further expansion both domestically and internationally of production capacity. Companies' investment plans may also be scaled back due to a high level of perceived risks and uncertainties, in order to develop resilience to possible "worst-case" scenarios regarding financial and economic conditions (UNCTAD, 2009).

Investment was the main driving force for developing-country growth over the past 5 years, contributing almost half of the increase in domestic demand. But the crisis will deal a negative shock to investment in developing markets. It is expected investment in middle-income countries in 2009 to grow at less than half the 2007 rate of 13 percent (Lin, 2008). In South East Europe, foreign direct investment is expected to decline sharply in 2009. The Economist Intelligence Unit predicts a decrease in FDI in some South East Europe countries.

The last channel of the crisis is remittances. Migrant remittances represent the most direct, immediate and far reaching benefit to migrants and their countries of origin. They are a more constant source of income to developing countries than official development assistance, foreign direct investment and other private flows. Moreover, the emergence of remittances as a new strategy for poverty alleviation in developing countries has spurred multilateral institutions, international organizations, and national governments, among others, to seriously study, identify and implement measures on how these inflows could be maximized and then harnessed for the development of migrants' countries of origin (Pant, 2008).

As labor markets slacken, foreign workers are likely to suffer disproportionate impacts on their earnings, which will reduce remittances. Remittances from host countries are expected to be decline in response to the global slowdown but the impact on flows to recipient countries will depend significantly on exchange rates. According to World Bank (2008) in 28 countries, remittances to developing countries were larger than revenues from the most important commodity export, and in 36 countries they were larger than private and

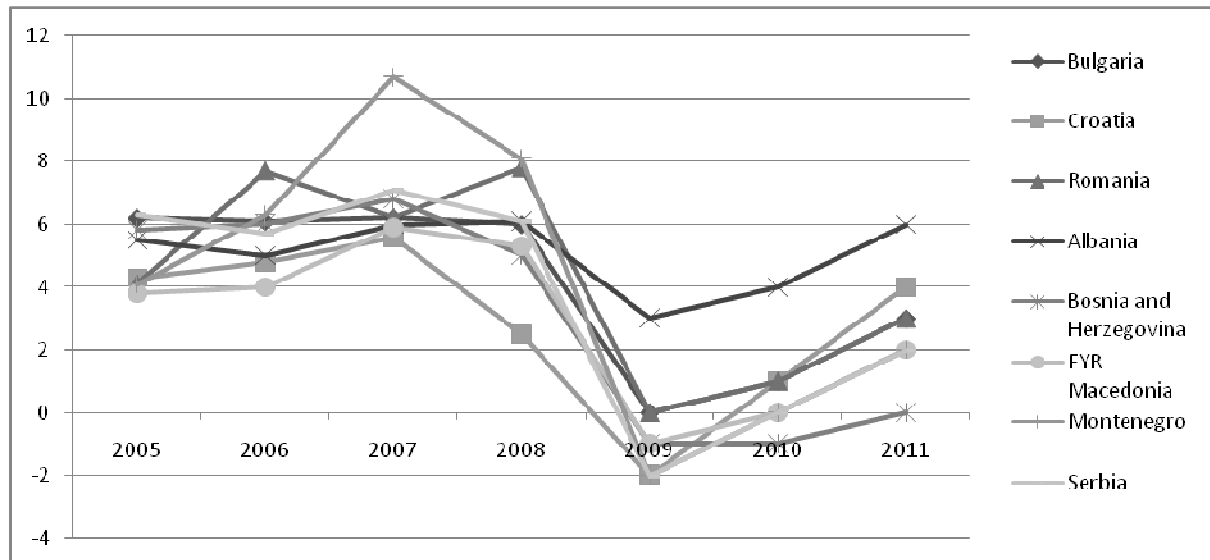
public capital inflows. They are also a powerful poverty reduction mechanism. For example, in Nicaragua remittances reduce poverty incidence by four percentage points on average, and five percentage points in urban areas. In Albania, households with migrants to Italy and Greece have an incidence of poverty that is half the national rate (i.e., 15 and 19 percent compared to an average of 32 percent). Remittance flows from host to developing countries, which reached an estimated \$295 billion in 2008, began slowing in the second half of 2008 and are projected to slow sharply in 2009.

### The Economic Sustainability in South East Europe

Economic sustainability requires that economic benefits exceed or at least balance costs and conditioned mainly by supply and demand. South East Europe Countries, under the current financial crisis, try to achieve their economic sustainability. Is it possible to achieve this aim for South East Europe countries next three years?

Following section tries to answer this question.

Before current financial crisis, the growth in real GDP in South East Europe was pretty good. Especially, Montenegro has a high growth rate. But most of them started to have a decrease in their GDP in 2007. According to estimates, the SEE countries are expected to suffer a significant drop in GDP: the Albania, Bulgaria, Croatia, Romania, Bosnia and Herzegovina, FYR Macedonia, Montenegro and Serbia. Graph 1 provides the developments 2005-2008 and outlook 2009-2011. The most of the countries in SEE may start growing again in 2010 and 2011. However, Bosnia and Herzegovina may take this process slower than the other SEE countries (Graph 1).



Source: EBRD Transition Report 2007; wiiw 2009. \*2009-2011 forecast.

**Graph 1:** Growth in real GDP in South East Europe, 2005-2011

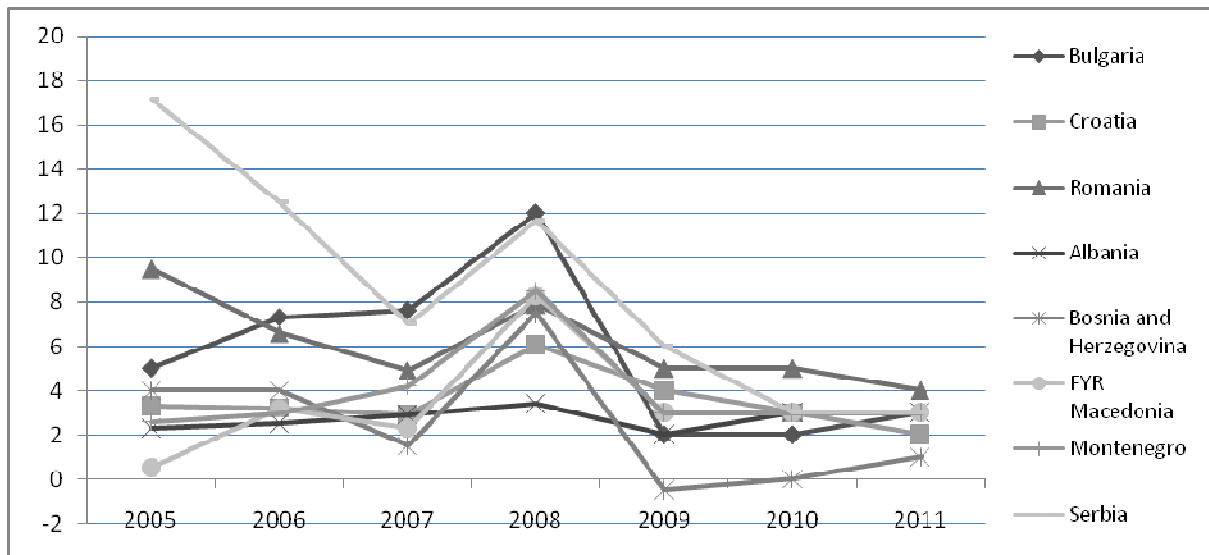
The degree of the financial openness shows integration with the rest of the world. Financial openness has followed a fluctuation during the past decade in the region. Although the financial crises in the end of the 1990s had a negative effect on the capital flows in SEE countries, the financial openness increased between 2001 and 2005 and the most of the SEE countries experienced an increase in the financial depth in this term. The amount of M2 as a percentage of GDP increased the most of the SEE countries: Albania, Croatia, Romania, Macedonia and Bulgaria. The other important thing is an increase in foreign banks in the region. The amount of foreign banks increased significantly in SEE countries between 1995 and 2006 (Terzi, 2009).

The SEE foreign banks and non-bank financial institutions have over the past decade accounted for more than half of the corporate lending market and two thirds of the home-loan business. The countries are strongly dependent on foreign currency lending, which has mainly been provided by foreign banks to their southeastern subsidiaries. With the credit freeze domestic banks and local companies are finding it increasingly difficult to refinance their foreign debt holdings. A lack of credit availability from foreign institutions is particularly dire when it is also affecting successful firms in the region. Export capacity in the region is dependent on trade finance being by local banks at affordable rates. But local credit availability is currently

drying up. Moreover, the interest rate on export finance loans to Bulgaria, Serbia or Romania has gone from 1.2 percent above libor to about six percentage point higher (Bastian, 2009).

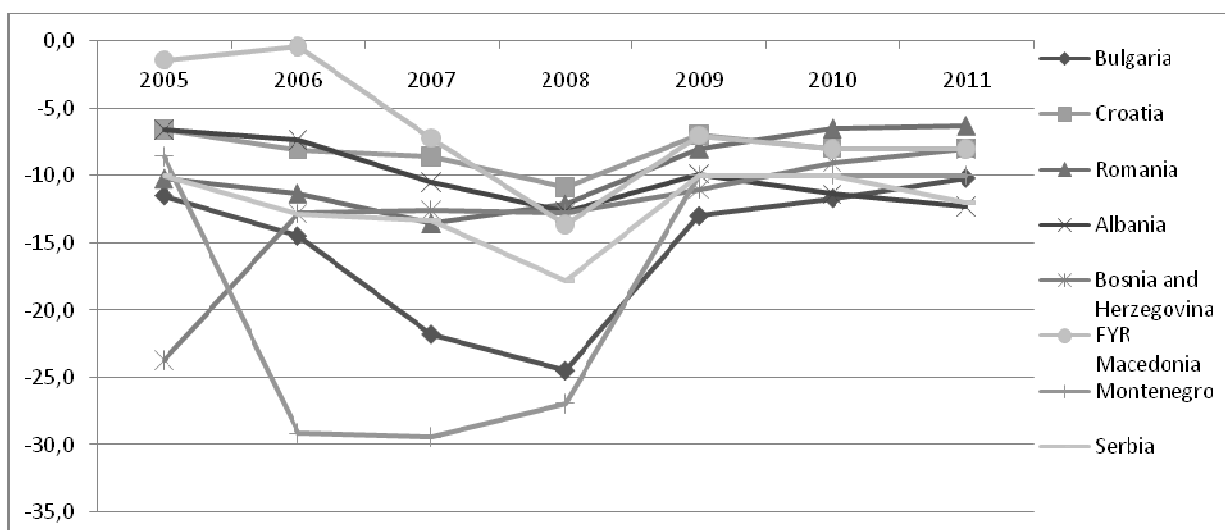
In addition, global financial crisis affected the external liabilities in the region. Data from the Bank for International Settlements shows that East, Central and Southeast European Banks accumulated total external liabilities to banks that report to the BIS of USD 1.657 trillion as of September 2008. USD 1.511 trillion of that total amounts is owed to euro-zone commercial banks (Bastian, 2009).

Another effect of the current financial crisis is on the consumer prices. Under the impact of the international crisis, the most of SEE countries have reached a point where high inflation is likely to depress credit growth in 2008 (EBRD, 2008). The inflation in the region is expected to decline in 2009. The forecasts in 2010-11 show that the inflation may increase again in this area (Graph 2).



**Graph 2.** Consumer Prices in South East Europe, 2005-2011 (change in % against previous year)  
Source: EBRD Transition Report 2007; wiiw 2009. \*2009-2011 forecast.

Current account deficit is important indicator for the countries to see the effect of the crises. All SEE countries, the current account deficit in 2008 exceed 10 % of GDP. It ran as high as 27% in Montenegro, 25% in Bulgaria and 18% in Serbia, while it ranged between 10 and 15 % in Albania, Croatia, Macedonia and Romania. The current account deficits in the SEE are high in general. As many East Europe Countries run large current account deficit, they are dependent on foreign capital and loans to continue their operations. The forecasts show a decrease in their current account deficits in 2010-2011( Graph 3).



**Graph 3.** Current Account in South East Europe, 2005-2011 (in % of GDP)  
Source: EBRD Transition Report 2007; wiiw 2009. \*2009-2011 forecast.

The government deficit in SEE countries will probably increase in both 2009 and 2010. The main reason will be a combination of lower revenues and overextended expenditures. The increase in expenditures will mainly stem from the need to support ailing financial and non-financial companies and pay out higher unemployment benefits. Under such circumstances, the countries in question will hardly be in a position to enact substantial demand-stimulating fiscal policies over a long period (wiiw, 2009).

In terms of foreign direct investment, the year 2008 marked the end of a growth cycle in international investment that started in 2004 and saw world foreign direct investment flows reach a historic record of \$1.8 trillion in 2007. Due to the impact of the ongoing worldwide financial and economic crisis, FDI flow decline by more than 20 per cent in 2008. A further decrease in FDI flows can be expected in 2009, as the full consequences of the crisis on transnational corporations' investment expenditures will continue to unfold (UNCTAD, 2009).

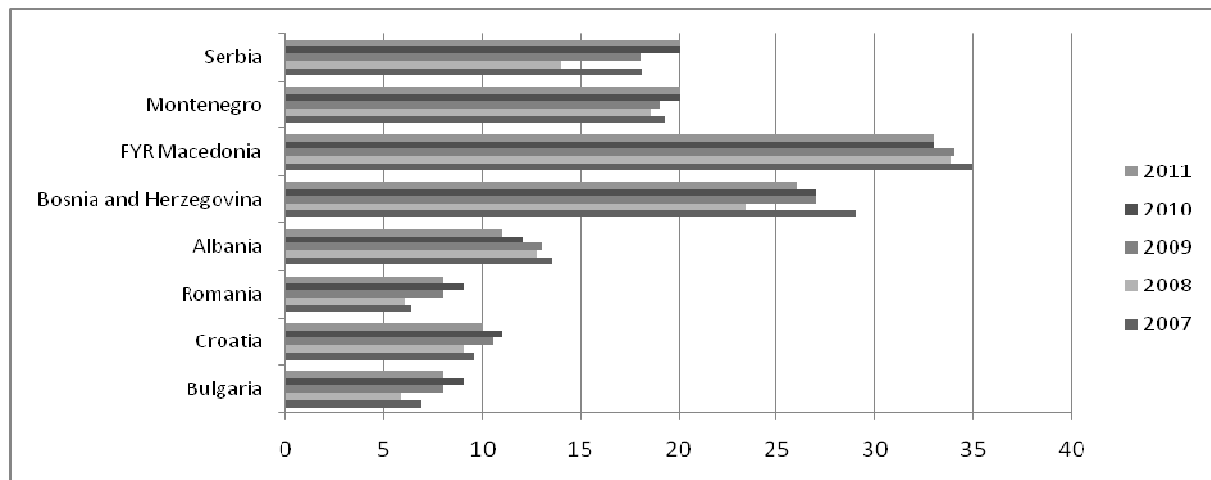
Romania is one of the most attractive countries in South East Europe in terms of foreign direct investment. Croatia and Bulgaria also attract the foreign direct investment. The rest of the region has less foreign direct investment than the other countries. Until 2007, the flow of foreign direct investment to South East Europe was pretty good (Tab.1). However, foreign direct investment is expected to decline sharply in 2009. The Economist Intelligence Unit predicts a decrease by 46 percent between 2008 and 2009, with FDI considerably declining in Romania, Montenegro, Serbia and Bulgaria.

**Table 1.** Foreign Direct Investment (in US\$ million), 2005-2007

	2005	2006	2007
<b>Bulgaria</b>	2,298	5,016	3,090
<b>Croatia</b>	1,548	3,516	2,363
<b>Romania</b>	6,587	11,430	9,600
<b>Albania</b>	265	300	400
<b>Bosnia and Herzegovina</b>	667	723	791
<b>FYR, Macedonia</b>	97	350	150
<b>Montenegro</b>	474	550	161
<b>Serbia</b>	1,481	4,400	3000

Source: EBRD, Transition Report, 2007

South East Europe countries experienced a high unemployment rates. The unemployment rate in the most of the region is more than 10%. Bosnia and Herzegovina, Macedonia, Montenegro and Serbia have a higher unemployment rate than the others. Moreover, the forecasts show that the unemployment in this region will continue to stay a high rate in next two years (Graph 4). Especially, the unemployment rates in Bulgaria and Romania are expected to come up a high level in 2009.



**Graph 4.** Unemployment, rate in %, annual average, 2007-2011

Source: wiiw, 2009; Labour Force Survey. \*2009-2011 forecast.

Migrant workers' transfers in the Southeastern Europe constitute a major economic factor. In 2007 remittances as a share of GDP reached 17.2 percent in Bosnia & Herzegovina, 10 percent in Albania (Tab. 2). Remittances slightly increased in 2008. But the economic crisis will leave its mark on migrant workers' continued ability to transfer such amounts back home. Many of these labors are employed in sectors adversely affected by the recession in their host countries, in particular in car manufacturing, construction and household

work. A decline in remittances from relatives working abroad will affect families and their income expectations during 2009 (Bastian, 2009).

**Table 2. Workers' Remittances in the SEE (US \$ Million)**

	<b>2007</b>	<b>2008</b>	<b>In % of GDP (2007)</b>
<b>Albania</b>	1.071	1.071	10.1
<b>Bosnia&amp;Herzegovina</b>	2.520	2.600	17.2
<b>Bulgaria</b>	2.086	2.200	5.7
<b>Macedonia,FYR</b>	267	315	3.6
<b>Romania</b>	8.533	9.000	5.6
<b>Serbia + Montenegro</b>	4.910	5.100	13.8

Source: World Bank estimates based on the International Monetary Fund's Balance of Payments Statistics Yearbook 2008 and World Bank, Migration and Remittances Factbook 2008.

## Conclusion

The world economy is going through difficult times. The turmoil in the international financial markets over the last year is having an increasingly adverse effect on the SEE countries. Under the current financial crisis, the growth in South East Europe will probably decrease and consumer prices will likely go down in 2009. South East Europe countries have been running current account deficits of 5 percent of GDP or more. These economies will be highly vulnerable to swings. The crisis will deal a negative shock to investment in South East Europe. This will lead to a decline foreign direct investment. Unemployment will continue to go up. And as labor market slacken, foreign workers are likely to suffer negative effects on their earnings, will reduce remittances. The full impact of the financial turmoil will depend on the behaviour of the countries economy policies in the next three years.

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