The Global Financial Crisis:

Preliminary Evidence in South East Europe and Responses from Governments

2nd Meeting of the SEE Working Group on Tax Policy Analysis

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1.1 Introduction

The countries of South East Europe (SEE) have seen strong growth in their economies over the past few years. In 2007, growth in gross domestic product (GDP) in the region reached 6.3%. [1] Political and economic risk in the region subsided, as witnessed by improved credit ratings from the three big credit rating agencies and increased foreign direct investment (FDI) inflows. In 2007, regional unemployment reached its lowest level since 1992 and GDP per capita climbed to USD 5,300. [2]

However, the current global economic crisis, heralded as the worst since the 1930s, creates severe challenges for economic growth in South East Europe. What began as a banking crisis in the West has turned into a general financial and economic crisis, exported to regions the world over. Although it is too early to fully analyse the impact of the crisis, data from late last year and the early months of 2009 indicate that it has spread to SEE. This paper aims to take stock of the current situation and examine the measures adopted by governments to mitigate the effects of the crisis.

The paper closes with a series of questions for possible discussion at the South East Europe Investment Committee meeting on 7th April 2009.

1.2 The crisis and South East Europe

Often described as an "imported" crisis, because its origins stem from countries in Western Europe and North America, the global downturn is affecting South East Europe. Due to falling demand from key EU trade partners, the region's exports are declining. This has fed through to lower industrial production, aggravated by reduced private consumption as remittances sink and growth in private credit has come to a standstill. Indeed, the Economist Intelligence Unit (EIU) predicts negative real growth of about -0.6 in the region for 2009.[3]

The next section describes key elements of the current economic situation in SEE, examining data on trade, industrial production, private consumption, inflation, FDI, commercial lending and government accounts.

1.2.1 Trade

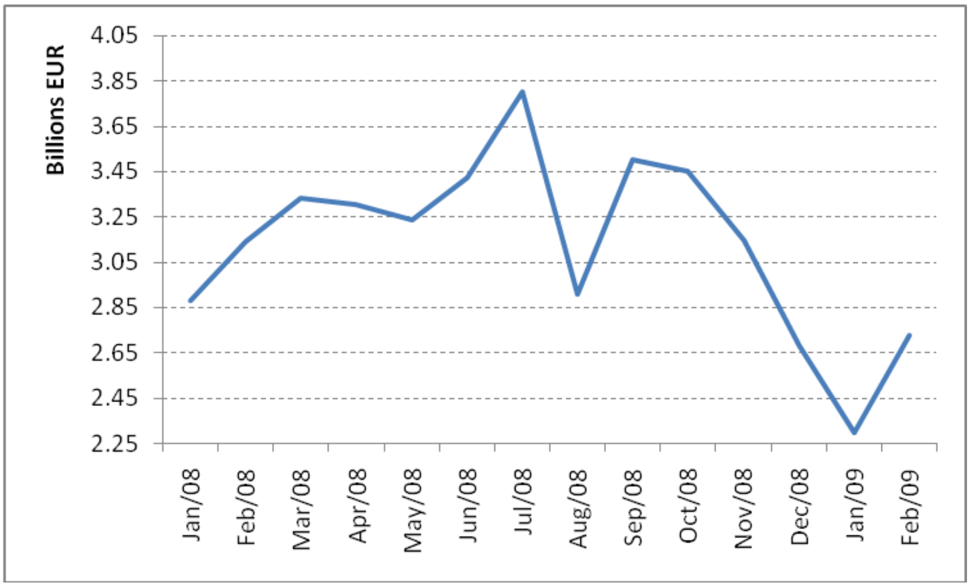
Export growth in SEE has slowed considerably as its main trading partners in the EU and other important regional markets experience recession. Total trade with the EU-25 in January was almost 40% lower than its peak in July 2008 (see Figure 1). Trade with the EU picked up slightly in February, although it was still 13% lower than trade in February 2008. Particularly hard hit have been the manufacturing and chemicals categories, which were both about one-third lower than the levels recorded in February 2008. Between July 2008 and February 2009 chemical exports from SEE to the EU fell at an average monthly rate of about 7%, while manufacturing exports fell on average 5% per month. Trade in construction-related materials, especially glass and metals, has dropped, and there have also been marked declines in exports of ready-made apparel, furniture and transport equipment, all important export industries for many SEE countries.

1 . EBRD data; average is calculated as a simple average.

2 . EBRD data; average is calculated as a simple average.

3 . EIU data; average is calculated as a simple average.

Figure 1. Total SEE exports to EU-25



Source : Eurostat

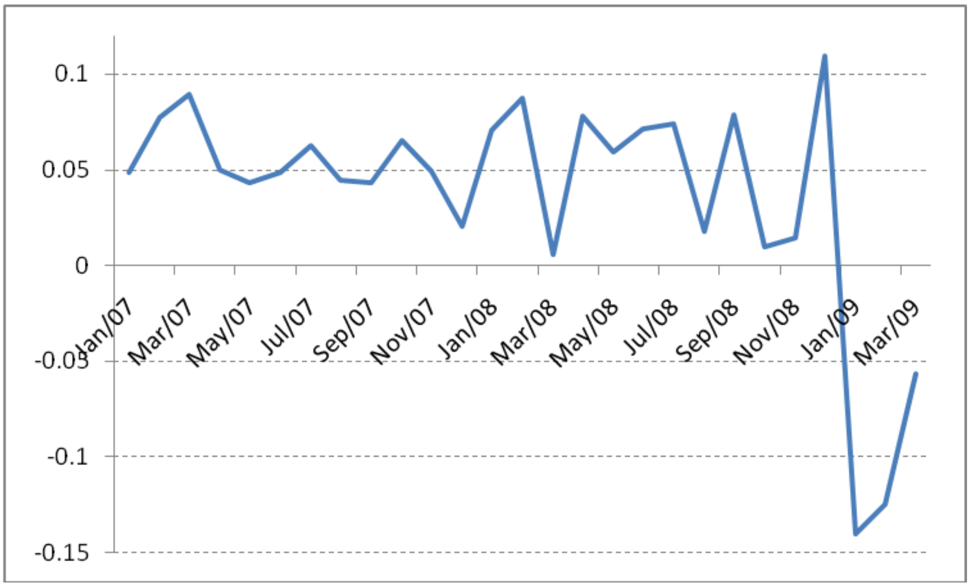
Albania's export contracted in late 2008 and early 2009 due largely to reduced demand in its largest trading partners: Italy, Greece and Germany. Bosnia and Herzegovina suffered from the collapse in commodity prices, especially for steel and aluminium. Croatian exports have also struggled, particularly in the face of the real effective appreciation of the kuna relative to the euro in 2008. In the Former Yugoslav Republic of Macedonia, merchandise exports declined by 32.2% year on year as of February 2009, largely because of lower demand for its main export products – metals and textiles. Although year on year exports in all SEE economies except Kosovo under UNSCR 1244 registered declines in February 2009, all SEE countries except the Former Yugoslav republic of Macedonia saw trade growth pick up between January and February 2009, and Bulgaria and Romania which have published export statistics up until March 2009 indicate exports grew during that month as well by 21% and 23% month on month, respectively. However, data for Croatia up until April indicates continued declining exports – month on month growth rates of -10% in March and -3% in April.

1.2.2 Industrial production

In almost all countries for which data are available, industrial production declined substantially in 2008 and early 2009. Growth in industrial production peaked in the first half of 2008. Average month on month growth was 6%. However, in growth from August to November slowed to about 3%. After production resumed at the Bosanski Brod oil refinery in Bosnia and Herzegovina, growth average growth in the region jumped to almost 11%. However, eliminating the Republika Srpska (Bosnia and Herzegovina) from the sample reveals industrial production contracted by 4%. Both January and February witnessed further declines by over 10% before declines slowed to -6% in March (see Figure 2). In some countries, in particular sectors, the decline in production was still more pronounced. For example, declining prices and reduced global demand resulted in a 50% month-on-month plunge in the mining of metal ores in the Federation of Bosnia and Herzegovina (FBiH) (Bosnia and Herzegovina) in December. Production cuts have already been announced by the country's main steel producer, Arcelor Mittal. Although production in mining has since increased slightly, manufacturing output contracted by 10.7% year on year. In Bulgaria, output of basic and fabricated metals fell by 16% in November, while the manufacture of basic metals fell by 58% for 2008 as a whole. At the end of 2008, low copper prices forced the suspension of operations at the Macedonian copper mine in Buchim. And in Montenegro, production in the mining and quarrying industry declined by 57% in December, while production has stopped at the country's main aluminium factory. However, as was the case in trade, it appears that industrial production is decreasing at a slower rate, particularly in the Federation of Bosnia and Herzegovina (Bosnia and Herzegovina), Croatia, the Former Yugoslav Republic of Macedonia and Romania.

Figure 2. Industrial production

Percentage change year-on-year



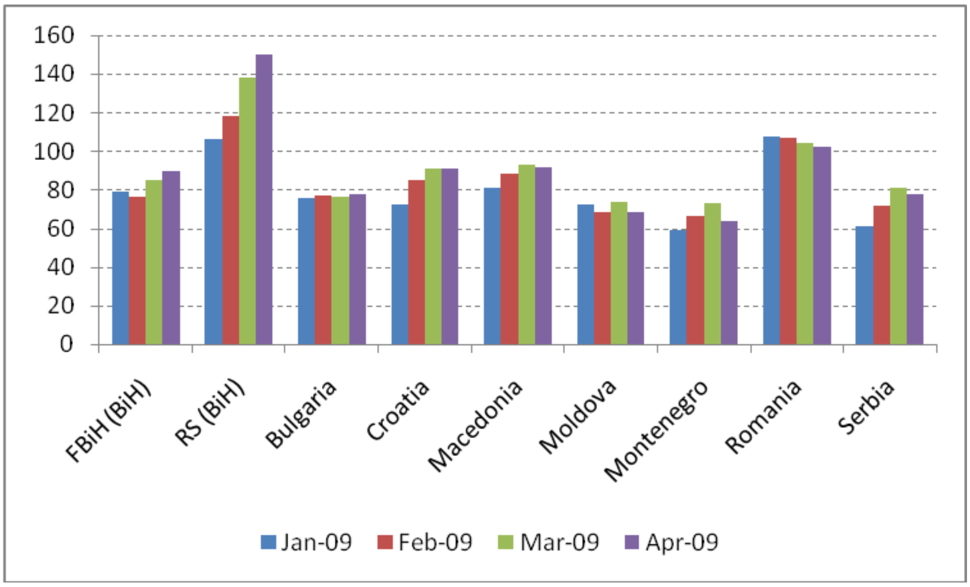
1. Data are a simple average for Bulgaria, the Federation of Bosnia and Herzegovina (Bosnia and Herzegovina), Republika Srpska (Bosnia and Herzegovina), Croatia, Moldova, Montenegro, the Former Yugoslav Republic of Macedonia and Romania.

Source : EIU and SEE national statistics agencies

However, it is not only the mining and metals industries that saw sharp production declines toward the end of 2008. Export-oriented manufacturing industries have suffered as demand from the euro zone flattened. Textiles and clothing, motor vehicles and machinery and equipment production were all affected. Romania, for example, experienced a major contraction in the production of transportation equipment. In Montenegro, manufacturing production declined starting in October, and in December was at its lowest since January 2004. Although manufacturing output in the Republika Srpska (Bosnia and Herzegovina) increased in December 2008, there were still significant production decreases in wood-processing and furniture manufacture. In fact, with the exception of the Bosnian entity Republika Srpska (Bosnia and Herzegovina), all countries in SEE for which data were available registered a reduction in manufacturing output relative to the same month of the previous year (see figure 3). However, since early 2009 industrial production has increased in almost all countries.[4] Manufacturing output in the Federation of Bosnia and Herzegovina (Bosnia and Herzegovina) increased by 13% month on month in April and it rose by 50% year on year in the Republika Srpska (Bosnia and Herzegovina).

[4] In Figure 3, year on year reductions in manufacturing output between January and April 2009 in Moldova and Romania actually hide month on month growth.

Figure 3. Manufacturing production indices



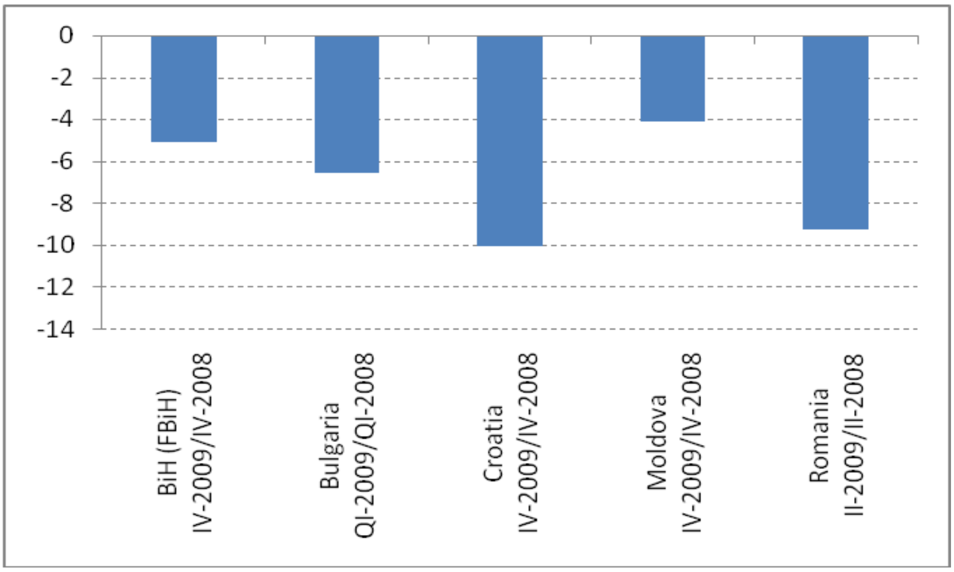
2. Indices compare production to production in the same month one year previously with the exception of Serbia, which compares production to the average production of 2008.

Source : SEE national statistics agencies

1.2.3 Private consumption

Domestic consumer spending and private consumption have fallen throughout the region due to weakened consumer confidence. In all economies where data were available, retail trade was consistently lower than in the same period one year previously (see Figure 4). Croatia had the largest decrease: in real terms, retail trade turnover in January 2009 was only 86.3% of that in January 2008 and continued to fall through February, before growing by 13.6% month on month in March.

Figure 4. Retail trade turnover indices



Source : SEE national statistics agencies

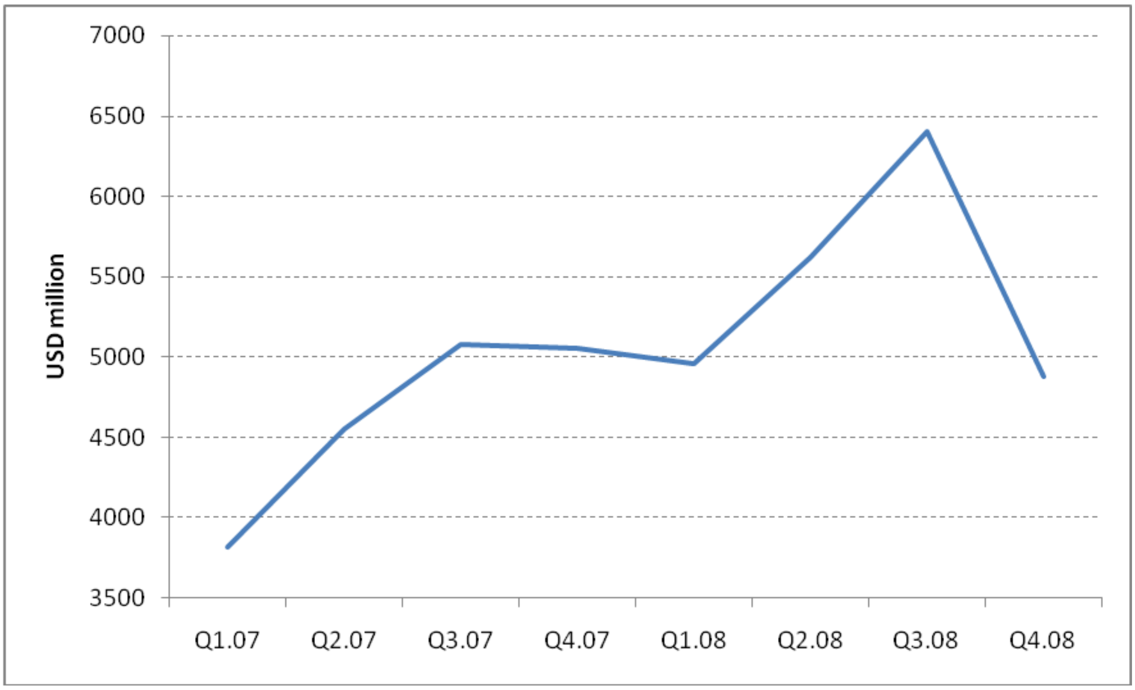
The Bulgarian National Statistical Institute indicator of retail sector confidence has declined steadily since late 2008, reflecting managers' grim assessment of future business prospects. In May many managers cited the "uncertain economic environment" and "financial problems" as the reason for their negative outlook. In Romania, the decline in retail trade was particularly evident in the sales of motor vehicles. In April, total motor vehicle and parts sales were down by 32% from April 2008 and sales of cars are down by over 33%.

In Moldova, growth in private consumption has declined from 8% in the first three quarters of 2008 to only 4.5% for the entire year. Remittances have been an important factor stimulating domestic consumption in Moldova and throughout SEE, and part of the decline in private consumption can be explained by reduced inflows of remittances. Remittance inflows, while generally less volatile in the face of external shocks than some other economic indicators, have started to decline in SEE. It appears that net current transfers[5] (which include remittance flows) in SEE peaked in the third quarter of 2008 but then fell over 23% in the fourth quarter (see Figure 5).[6] Current transfers fell between the third and fourth quarter for all countries except Montenegro, where they grew by 3%, and Serbia. In Bosnia and Herzegovina current transfers fell by 28%, in Croatia by 11%, in Moldova by 7%, and in Romania by 44%. Bulgaria and the Former Yugoslav Republic had the biggest fall in current transfers, by 38% and 46% month on month, respectively. Current transfers in Serbia did increase between the third and fourth quarters but they fell back again slightly in the first quarter of 2009.

5 . Current transfers include worker remittance flows, donations and gifts (e.g. international aid), etc. As disaggregated data on remittances are not available in many SEE countries, current transfer data are used as a proxy.

6. Data include Albania, Bosnia and Herzegovina, Bulgaria Croatia, the Former Yugoslav Republic of Macedonia, Moldova and Montenegro.

Figure 5. Net current transfers

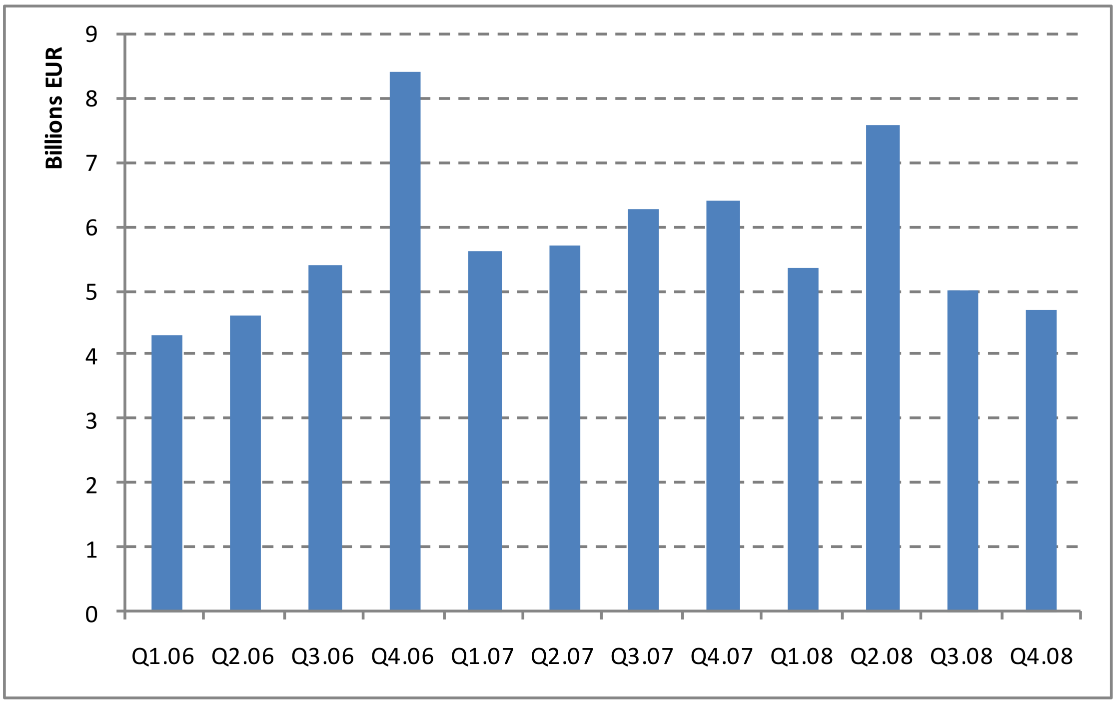


Source : SEE central banks; Data are for Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Moldova, the Former Yugoslav Republic of Macedonia, Montenegro, Romania and Serbia.

1.2.4 Foreign direct investment

Although it is probably too early to fully analyse the impact the crisis is having on FDI inflows, the data for the second half of 2008 and early 2009 point to a decline. After reaching a record high of EUR 7.6 billion in total net foreign direct investment in SEE, FDI dropped off in the third quarter dramatically. Net FDI in the third quarter was EUR 4.8 billion, 37% lower than in the second quarter (see Figure 6). The trend continued in the fourth quarter, where FDI inflows fell by another 6%. In Bulgaria, the Former Yugoslav Republic of Macedonia, Montenegro and Romania, data on the fourth quarter indicate a continuation of the downward trend: FDI in those countries fell by 36%, 20%, 12% and 9%, respectively compared to the third quarter of 2008. FDI surged again during the fourth quarter in Albania, Croatia and Serbia, however fourth quarter data often increase due to statistical reclassification of previous inflows. While quarterly data on FDI are not available for Kosovo under UNSCR 1244, it displays a similar situation: FDI in 2008 was EUR 3.6 million, 15% lower than the 2007 inflows.

Figure 6. Total FDI in SEE



Source : SEE central banks

Data from the National Bank of Serbia suggest that the industries in that country suffering from the sharpest decline in FDI are agriculture, hotels and restaurants, financial intermediation and manufacturing, mirroring the pattern of declines in industrial production and trade. Each of those industries witnessed a 40-60% drop in FDI between the first and fourth quarters (see Table 1). While FDI increased in slightly in the first quarter, all industries with the exception of construction were significantly below FDI levels in the first quarter of 2008. In manufacturing, food processing, apparel, chemicals and plastics, machinery, equipment and computers were particularly affected.

Table 1. FDI by branch of activity in Serbia

EUR thousands

	I Q 2008	II Q 2008	III Q 2008	IV Q 2008	I Q 2009	I Q 2008/I Q 2009
Agriculture	19,512	7,675	10,496	545	6,058	31%
Mining and quarrying	1,214	2,445	1,459	14,445	n/a	n/a
Manufacturing	127,351	154,970	49,174	56,982	63,084	50%
Electricity, gas and water supply	n/a	700	996	651	533	76%
Construction	10,241	8,584	20,642	16,117	11,316	110%
Wholesale and retail trade, repair	38,011	95,724	78,001	64,211	34,556	91%
Hotels and restaurants	12,416	983	1,494	837	1,916	15%
Transport, storage and communications	48,634	42,224	35,711	41,525	43,074	89%
Financial intermediation	501,567	231,034	51,673	76,761	40,878	8%
Real estate, renting and business activities	90,222	147,629	83,197	87,783	68,589	76%

Other communal, social and personal service activities	6,284	6,745	2,388	2,978	6,104	97%
Total	**752,622**	**565,185**	**135,929**	**206,731**	**241,731**	**32%**

Source : National Bank of Serbia

Anecdotal evidence throughout SEE also points to declining FDI inflows. Newspaper reports and other sources confirm that many FDI commitments are being delayed or cancelled due to declining demand or uncertainty about firms' economic future and the economic stability of the region. Examples include the following:

- The Czech energy group Cez has discontinued plans to invest in a mine in Bosnia and Herzegovina.

- The Brazilian mining and metallurgical firm CSN has delayed investment in a Bulgarian steel manufacturer.

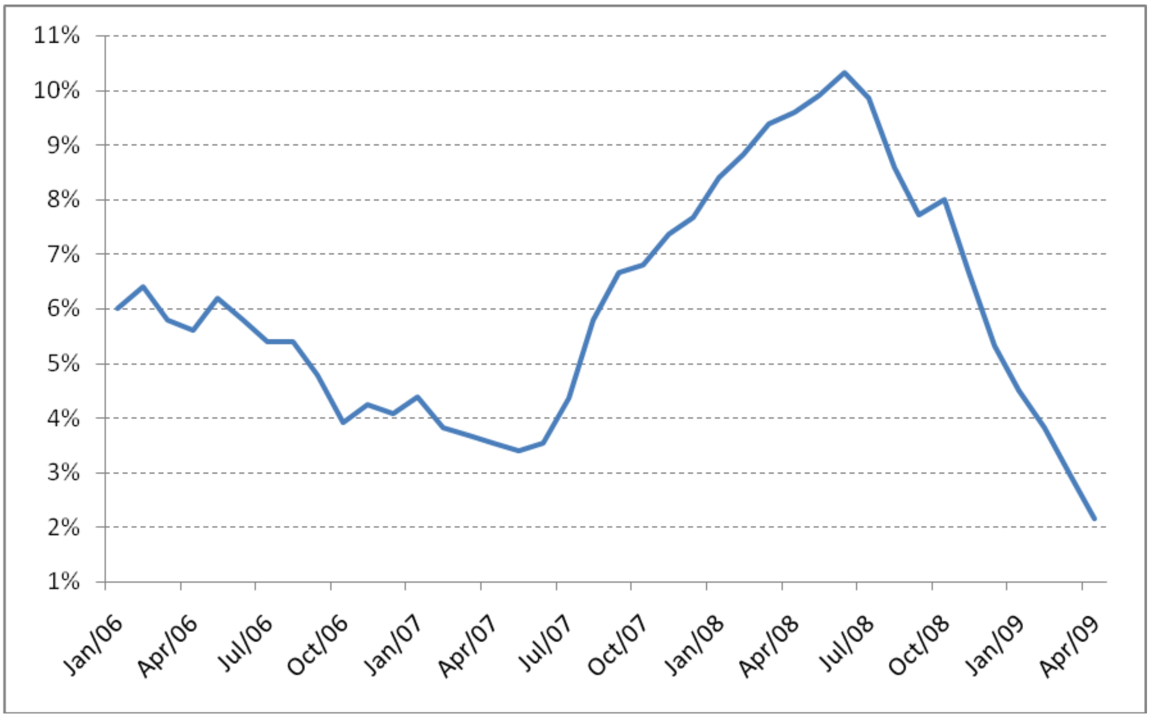
- Citing the economic crisis, a consortium of Russian and Ukrainian firms has withdrawn from a contract to purchase Serbia's Prva Petoletka, a hydraulic and pneumatic components producer.

1.2.5 Inflation

Since the middle of 2007 most SEE countries experienced higher rates of inflation, averaging 10% in May 2008, reflecting increases in the international price of oil and surging food prices. However, the fall in world energy prices, the decline in food prices and the slowdown in consumer consumption have served to weaken inflationary pressures in all countries. Growth in consumer prices fell to an average of 2% year-on-year in April 2009 (see Figure 7).

Figure 7. Consumer price changes

Percentage change year-on-year



3. Data are a simple average for Albania (quarterly data until third quarter 2008), Bulgaria, Bosnia and Herzegovina, Croatia, Moldova, Montenegro, the Former Yugoslav Republic of Macedonia and Romania.

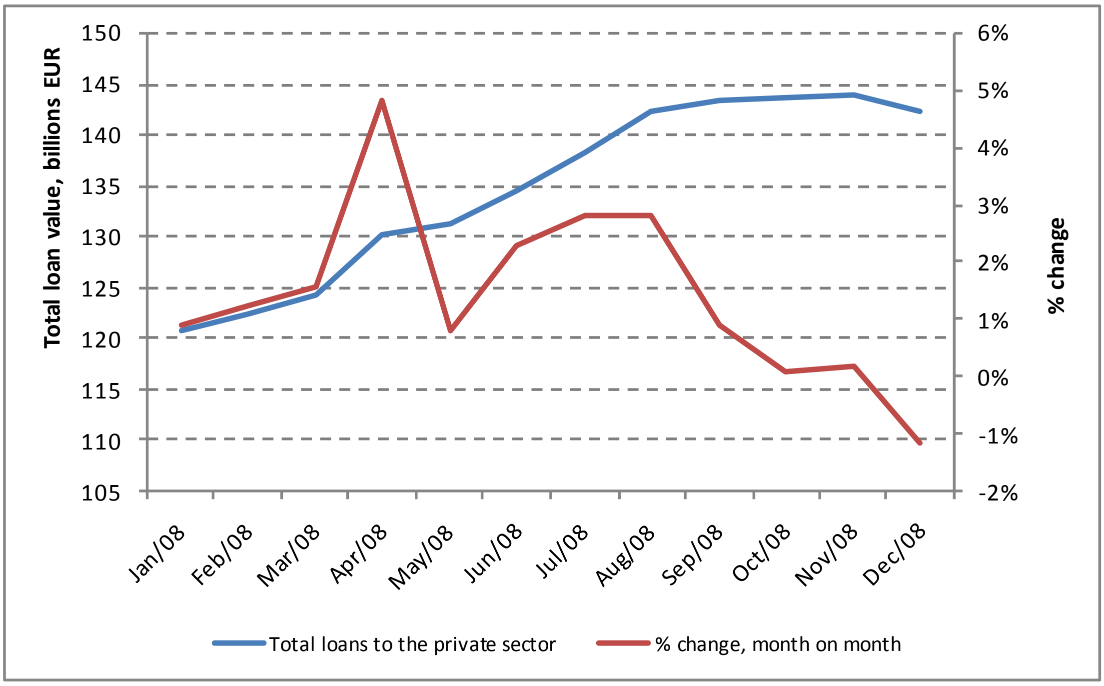
Source : EIU, SEE national statistics agencies

In Bulgaria, average consumer prices increased by 12% in 2008 and price increases reached 15% in May through June before falling back to 5% in April. In Croatia, consumer prices peaked at 8.4% in July but then came down to 2.9% in December 2008, the lowest level of inflation for 16 months, although growth as since increased to 4% in April 2009. In Moldova, prices reached 17.1% in May but fell significantly to 1% in Marcy 2009 and actually decreased by 3% in April 2009. Albania, Bosnia and Herzegovina, the Former Yugoslav Republic of Macedonia and Romania have also seen falls in consumer price inflation. However, in Romania the fall has been more gradual due to the recent depreciation of the leu.

1.2.6 Lending

The first half of 2008 and the two previous years were characterised by rapid growth in lending by commercial banks. However, commercial lending has stagnated and even declined in some countries with the onset of the financial crisis (see Figure 8). In all countries, growth in credit in the last monthly period for which data were available was less than 1%, with the exception of Moldova, where total loans to the private sector actually increased by 10% between January and February. In many countries credit growth was negative. Indeed, this contraction of credit is expected to be particularly painful for SEE, as buoyant credit conditions have for some time supported growth in the region.

Figure 8. Loans to the private sector in SEE



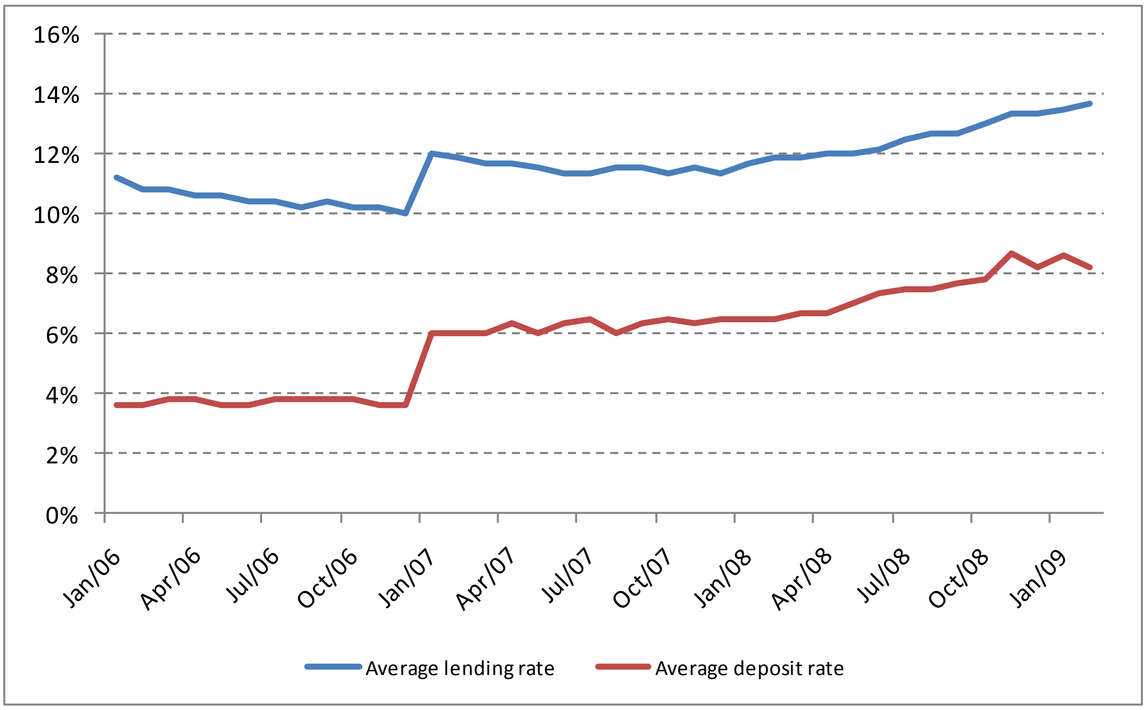
4. Data include loans to the business and household sectors.

Source : SEE central banks

In Albania, total loans to the private sector declined by 0.5% in December, and the IMF predicts further credit contraction. In November, in Bulgaria, the banking sector only disbursed BGN 900 million in loans, the lowest level in over two years. In the first half of 2008, the commercial banking sector made average monthly loans of BGN 2-2.5 billion (EIU, 2009). Lending controls implemented by the Croatian National Bank have served to reduce earlier credit growth in that country (EIU, 2009).

At the same time, average lending and deposit rates have pushed upwards. Average lending rates for SEE (excluding Albania, Bosnia and Herzegovina and Kosovo under UNSCR 1244) were almost 16% in February, compared to 13% in January. Deposit rates have also increased, from 6.5% in January 2008 to almost 8% in February 2009 (see Figure 9). In Croatia on January 27 2009 the Zibor interest rate on overnight loans shot up to 25.6%, from 20.4% the previous day. As a result, the Croatian National Bank intervened in a reverse report auction the next day at a fixed interest rate of 6%, bringing the Zibor down to between 5-10% (EIU, 2009).

Figure 9. Lending and deposit rates

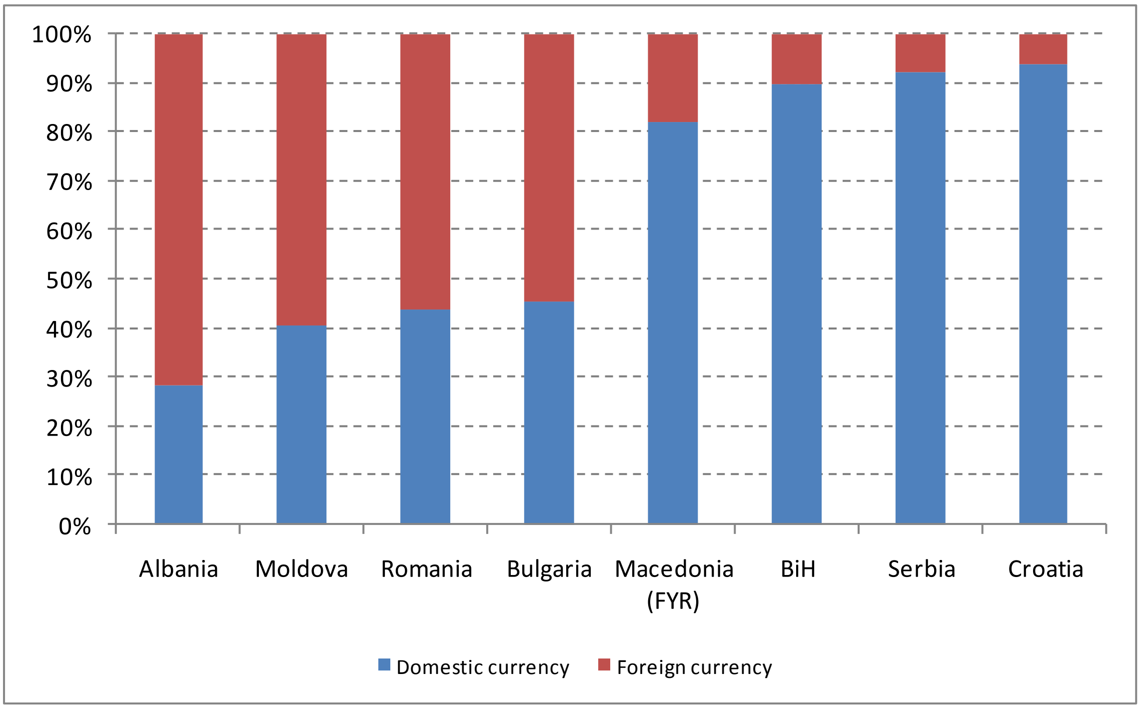


Source : EIU

Several central banks have instituted measures to encourage further lending. The Bank of Albania, the National Bank of Moldova, the National Bank of Romania and the National Bank of Serbia have recently cut interest rates. The Central Bank of Bosnia and Herzegovina and the Bulgarian National Bank, constrained in adjusting monetary conditions by their currency Boards, have reduced reserve requirements. Other central banks in the region have taken similar steps (see Section1.3.1 for more information).

Another worry in the banking sector is the stock of foreign-currency debt. Many countries have had relatively stable exchange rates against the euro and other currencies, encouraging their citizens to take advantage of the lower interest rates offered on loans in these currencies (see figure 10). However, recent currency depreciations in many countries serve to increase the domestic currency value of those loans. In Albania, foreign currency loans represented 72% of total loans to the private sector in January 2009, a figure which has remained relatively stable over the past year. Meanwhile, the Albanian lek has depreciated from 122 ALL:EUR in January 2009 to almost 130 ALL:EUR in March 2009.

Figure 10. Currency denomination of loans to the private sector



5. Data represent the percentage of loans made to the private sector that are in domestic or foreign currency. Data are represented as an average of monthly stock over the last 12 months. Data for Bosnia and Herzegovina represent loans made to the entire economy.

Source : SEE central banks

In Moldova, foreign currency loans also represent a significant portion of total lending to the private sector – about 40% in February 2009. However, data from the National Bank of Moldova indicate that foreign currency denominated debt is declining faster than debt in leu, reflecting borrower apprehension about the exchange rate (EIU, 2009).

In Romania, households have taken out a large portion of the total stock of foreign currency denominated debt. They have therefore been particularly affected by the recent depreciation of the leu (the leu has appreciated by 15% since March 2008). In December the depreciation of the leu increased the domestic currency value of the stock of household loans denominated in foreign currencies by almost 5%, to ROL 5.8 billion. This occurred despite the fact that over EUR 1 million of the stock of debt was paid down or matured during that period, while growth in new credit was small.

1.2.7 Government accounts

In recent years, despite record tax receipts, few governments in the region have recorded a budget surplus. Bosnia and Herzegovina, Croatia, Moldova and Romania all recorded a budget deficit in 2007 (see Table 2),[7] and according to EIU estimates, the Former Yugoslav Republic of Macedonia has probably joined that list for 2008. Only Bulgaria enjoyed a budget surplus, of 3.8% of GDP in 2007, and an

7 . EIU data; figure for Bosnia and Herzegovina is an estimate.

estimated 3% of GDP in 2008.[8] Such surpluses can of course be used to expand fiscal stimulus policies, and are particularly important for SEE countries as these are often restricted in borrowing on the private credit market compared to other countries, especially those from the EU.

Table 2. Government budget balance (% GDP)

	2004	2005	2006	2007	2008
Bosnia and Herzegovina	-0.60%	1.00%	2.20%	-0.30%	-2.00%
Bulgaria	1.70%	3.10%	3.60%	3.80%	3.00%
Croatia	-2.70%	-1.80%	-0.70%	0.20%	-0.40%
Macedonia (FYR)	0.40%	-0.80%	-0.60%	0.30%	-0.80%
Moldova	0.40%	2.00%	-0.30%	-0.30%	-1.00%
Romania	-1.00%	-0.80%	-1.50%	-3.20%	-4.90%
Serbia	-2.04%	2.31%	2.47%	0.97%	-3.58%
Average	**-0.55%**	**0.72%**	**0.74%**	**0.21%**	**-1.38%**

6. Figures for 2007 and 2008 are EIU estimates except Moldova 2007 and Serbia. Average is calculated as a simple average

Source : EIU, National Bank of Serbia

Moreover, many SEE countries can expect to see their budget deficits increase (and in the case of Bulgaria, contract) due to higher debt payments and lower tax revenues.[9] Total external debt stock in the region in 2007 was about USD 200 billion, equivalent to approximately 58% of total SEE GDP (see Table 3). In 2008 external debt stock is estimated to have reached USD 240 billion, a 24% increase from the previous year, despite much slower GDP growth.[10] This growth of external debt translates into higher future interest and principal payments for many countries.

Table 3. External debt stock (% GDP)

	2004	2005	2006	2007	2008
Albania	18.53%	16.18%	16.83%	15.85%	
Bosnia and Herzegovina	52.33%	49.19%	46.22%	46.83%	44.23%
Bulgaria	63.38%	57.59%	66.03%	83.55%	88.88%
Croatia	91.59%	78.30%	87.32%	90.09%	90.86%
Moldova	74.90%	68.70%	70.89%	75.09%	66.19%
Macedonia (FYR)	38.28%	38.89%	42.46%	47.37%	49.21%
Romania	39.18%	39.51%	44.92%	45.98%	46.38%
Serbia	57.50%	58.96%	61.69%	63.10%	69.02%
SEE average	**54.46%**	**50.92%**	**54.54%**	**58.48%**	**64.97%**

7. Data for 2007 and 2008 are EIU estimates in Bosnia and Herzegovina, Bulgaria, Croatia, Moldova, the Former Yugoslav Republic of Macedonia and Romania. SEE average calculated as a simple average.

Source : EIU, Bank of Albania, National Bank of Serbia, World Bank

8 . EIU data; estimate.

9 . Budget expenditures will also increase with expansionary fiscal policy although this is discussed in Section 1.3.2.

10 . Nominal GDP is estimated to have increased by 18% between 2008 and 2009 while real GDP growth is estimated to have been about 5%

Although it is still too early to fully examine the impact the crisis has had to date on taxation revenue, government revenues in Bulgaria and the Former Yugoslav Republic of Macedonia fell by 6% and 7% in the fourth quarter of 2008, respectively. In SEE, taxes on goods and services (e.g. value added tax) represented 71% of total tax revenues in 2007. However, lower remittances and lower private consumption (described in Section 1.2.3) can be expected to lead to lower VAT receipts. In fact, Bosnia and Herzegovina has already recorded a decline in indirect taxation receipts in the second half of 2008. Croatia also reported lower than expected VAT receipts in January and February 2009 (EIU, 2009).

1.3 The policy response

As the negative impacts of the global crisis make their way across SEE, governments are employing different mechanisms to improve their competitiveness and encourage economic activity. As a first step, improving competitiveness can come through currency depreciations (see Figure 11 for an indication of regional depreciations). However, for some countries depreciation is not an option because their currencies are pegged to the euro through a currency Board (Bosnia and Herzegovina, Bulgaria), they are *de facto* pegged to the euro (the Former Yugoslav Republic of Macedonia) or the euro is *de jure* legal tender (Kosovo under UNSCR 1244 and Montenegro). For these countries, in the absence of a rapid increase in export competitiveness, or an increase in external financing, short-term adjustment must come through some degree of deflation. As explained in Section 1.2.5, although no country in the region is experiencing outright disinflation, the latest statistics on prices show a generalised slowing of inflation. This might give some relief to countries that have some form of fixed exchange rate.[11]

Beyond currency depreciations, SEE countries can employ other monetary and fiscal policy instruments to ease adjustment and encourage economic activity, including fiscal spending programmes to encourage aggregate demand or loosening of lending controls to increase liquidity in the banking system. The following sections describe the monetary and fiscal policies employed by SEE countries to counteract the effects of the crisis.

1.3.1 Monetary policy

Consumer price increases in the first half of 2008, while partly reflecting local economic conditions, were mostly due to the impact of high global food and energy prices. During this time, monetary authorities were more interested in maintaining high interest rates and introducing administrative lending controls in order to keep inflation and rapid credit expansion in check. However, as described in Section 1.2.5, these developments gave way to slowing rates of inflation in the second part of 2008 and in the early months of 2009, providing central banks with more room to increase liquidity in the domestic banking sector. Among the monetary, prudential and administrative policy tools at the disposal of the central banks are the following:

Measures to increase liquidity and boost credit to households and firms. Some central banks of the region have been cutting their main policy rates since the end of 2008 (Albania, Moldova, Romania and Serbia). They have also reduced minimum reserve requirements and reserve requirements for funds borrowed from abroad (Bosnia and Herzegovina, Bulgaria, Croatia, Moldova, Montenegro, Romania, Serbia).[12] Some central banks have exempted funds in foreign currency from reserve requirements (Bosnia

11 . However, it is unclear whether this will lead to depreciation of the real effective exchange rate, as disinflationary pressure can also be witnessed in the euro area, which is the region's main trading partner (Gligorov and Landesmann, 2009).

12 . For countries with fixed exchange rates or dollarization, reduction in minimum reserve requirements is the only monetary policy instrument available to monetary authorities operating in this environment.

and Herzegovina, Romania, Serbia). In addition, some central banks are pumping liquidity into the banking system through regular reverse repurchasing auctions (Croatia).

Table 4. Monetary policy tools in SEE since September 2008

Country	Reserve requirements	Interest rates
Albania		January 2009 – reduced the policy rate from 6.25% to 5.75%
Bosnia and Herzegovina	April 2009 – cut reserve requirement ratio for deposits with a maturity greater than or equal to 12 months from 10% to 7%. December 2008 – cut reserve ratio for all deposits from 18% to 14%. November 2008 – removed reserve requirements on new credit lines from abroad.	
Bulgaria	December 2008 – reduced reserve ratio for commercial banks from 12% to 10%. January 2009 – reduced reserve requirement for funds borrowed from abroad from 10% to 5%.	
Croatia	December 2008 – reduced reserve ratio for commercial banks from 17% to 14%.	
Moldova	December 2008 – reduced bank reserve requirements (for leu and foreign currency) from 19% to 17%.	May 2009 – cut the main interest rate from 11% to 10%.
Montenegro	February 2009 – reduced reserve requirements to a flat rate of 11% on all deposits.	
Romania	November 2008 – reduced minimum reserve requirements on leu-denominated liabilities from 20% - 18%. March 2009 – cut minimum reserve ratio on liabilities denominated in foreign currency with a maturity over two years from 40% to 0%.	May 2009 – reduced the monetary rate from 10% to 9.5%.
Serbia	December 2008 – slashed reserve requirements on foreign credit, subordinated credit and financial leasing to 0% (until June 2010).	June 2009 – reduced key policy rate from 14% to 13%.

Source : SEE Central Banks, EIU

Measures to encourage lending in local currency. These aim at improving the effectiveness of monetary policy transmission mechanisms and mitigating currency risk. Specifically, central banks are demanding more transparency from commercial banks and requiring them to provide explanations regarding exchange rate risk. Central banks are also introducing tougher provisions on foreign-exchange lending. The Central Bank of Albania has been encouraging local banks to enhance transparency with clients when issuing loans denominated in foreign currency. The aim has been to ensure that borrowers understand the exchange rate risk associated with foreign currency loans.

Measures to prevent potential bank runs. Following instances of deposit withdrawals, and in order to put domestic banks on an equal footing with parent banks headquartered in the EU, several countries have increased the ceiling for the sums guaranteed to depositors (Albania, Bulgaria, Bosnia and Herzegovina, Croatia, Montenegro, Romania and Serbia). Some countries only provide guarantees to deposits held by households, not firms. Another measure to discourage households and firms from withdrawing their deposits consisted in scrapping taxes on savings held in commercial banks (Serbia). To date, there has been only one instance of a government in the region having to bail-out a private bank (Montenegro).

However, while all countries are using monetary policy, some are more cautious than others. In Moldova, Romania and Serbia inflationary pressures, albeit reduced, remain pronounced and could easily reignite. Moreover, exchange rate fluctuations are leading these same countries to conduct a somewhat more cautious monetary policy. Together with Croatia, these countries are also intervening in foreign-exchange markets to guard against excessive depreciation.

1.3.2 Fiscal policy[13]

The importance of expansionary fiscal policies is not just that they allow for an increase in aggregate demand. Fiscal stimulus, where feasible and effective, could also reduce pressure for “beggar-thy-neighbour” measures such as competitive devaluation. However, as described in Section 1.2.7, few countries in the region have achieved budget surpluses that could now be deployed through counter cyclical spending. For most, the room for fiscal manoeuvre is limited by the statee of their public finances and the need to rein in spending at a time when tax revenues are likely to fall and the domestic-currency costs of debt repayments are set to rise. In addition, most governments in the region cannot ease fiscal policy promptly because they lack the ability to gather necessary liquidity in a timely manner.

In spite of the somewhat limited room for policy manoeuvre, all SEE economies are adopting forms of expansionary fiscal policies. These include attempts to shift budget expenditure away from current spending and target forms of capital investment (including education, healthcare, road and rail infrastructure, municipal infrastructure and information technology). Governments across the region are trying to create additional room for fiscal manoeuvre by increasing spending efficiency. Accordingly, some SEE governments are introducing measures aimed at cutting public administration costs and are also urging state-owned enterprises to devise saving plans (Bosnia and Herzegovina, Croatia, Romania and Serbia). A typical example of a measure to rein in spending while freeing up resources for structural investment is seen in attempts to reduce the rate of public sector wage increases and pensions.

SEE governments are also using tax breaks and capital investment expenditure to shore up industries – such as construction – that are experiencing the most significant reductions in demand. Tax cuts have been implemented in some SEE economies (Kosovo under UNSCR 1244, the Former Yugoslav Republic of Macedonia and Montenegro). However, fiscal discipline requirements have prompted some governments to introduce temporary new taxes, for example property taxes, luxury items taxes and capital gains taxes (Serbia). Budget expenditure has also been earmarked for infrastructure spending, providing for short- to medium-term job creation and upgrading of the transport system (Albania, the Former Yugoslav Republic of Macedonia and Romania).

As commercial banks are tightening credit availability to firms, some SEE governments are providing funds to state-owned development banks in order to facilitate lending (with guarantees) to small and

13. The sustainability in public finance in SEE is not as problematic as it is in some EU member states. However, risks associated with most SEE countries restrict the ability of governments to borrow in the private credit market. This limits their ability to increase counter cyclical expenditure in the presence of declining revenues.

medium-sized enterprises (Bulgaria, Croatia, Romania, Serbia). While in some countries the use of these funds is in principle open to all small firms, other countries are directing funds either to specific industries or to export-oriented sectors.

Another measure to sustain industrial production and stimulate consumption consists in subsidising interest rates on working capital loans and capital investment loans to firms, as well as subsidising consumption credit to households (Serbia). In some cases, the provision of these loans also aims at preventing job shedding (i.e. companies cannot fire workers while benefitting from subsidised credit) or is conditional upon "buy-national" requirements (e.g. households can take out loans at reduced rates only to finance the purchase of domestically produced goods).

Finally, some SEE governments have pledged to complement the triggering of automatic stabilisers by increasing assistance to the poorest income groups through targeted transfer programmes (Croatia, Romania, Serbia). Such programmes often result in a relatively larger stimulus to aggregate demand, as lower income groups typically have a higher propensity to consume.

1.4 Discussion points

- How are current policy responses to the crisis affecting the trade-off between short- and long-term growth prospects?

- In what ways can policymakers respond to the crisis without undermining long-term productivity growth?

- What will be the impact of current fiscal and monetary policies on the sustainability of public finances and the competitiveness of SEE economies?

- Besides trade integration, in what other policy areas could regional initiatives help cushion the impact of the crisis?

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