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Current Issues
Emerging markets

Western Balkans

Bumps on the road to EU accession

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We assess the economic outlook for the Western Balkan region, including Croatia, Serbia, Albania, Bosnia-Herzegovina, Macedonia, and Montenegro. Each country in the region is on the road to EU accession, though they are at very different stages of the process. The most advanced, Croatia, is set to become the EU's 28th member towards the middle of next year. For the rest, it could be a long road given the economic and political challenges that they face, and also a sense of enlargement fatigue among some existing member states.

The recent economic performance of the region has been mixed. Growth fell as a result of the global financial crisis and subsequent stress in the euro area and is set to recover only gradually. But the pattern has not been uniform with economies that are more open and integrated with the European economy, such as Croatia, tending to be harder hit.

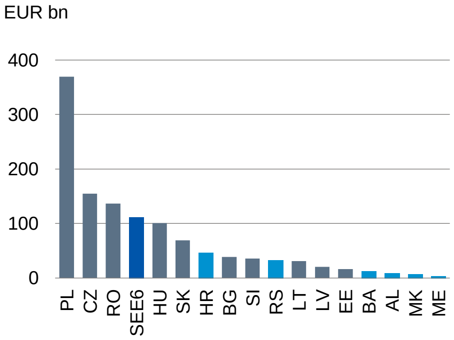
Given its geographical location, the region's vulnerability to the euro crisis is self evident. The euro area accounts for about half of all exports, with Italy generally the most important export market for the region. Remittances, which account for about 9% of GDP on average, represent another potential source of contagion, though evidence that these flows have been adversely affected by the euro crisis is mixed.

European banks have also developed a strong presence in the region, accounting for 75-90% of banking system assets, which is a touch higher than in Central Europe. Gradual deleveraging is taking place and credit growth will therefore likely remain subdued and constrained mainly by the pace of growth in domestic deposits.

Policymakers have limited room for manoeuvre. Fiscal deficits widened sharply after the last crisis and this policy space has not yet been rebuilt. Public debt is set to reach about 48% of GDP on average this year. The emphasis in most countries, therefore, is still on fiscal consolidation. Monetary and exchange rate policies are even more constrained: most countries have pegged their exchange rates (formally or informally) to the euro; and those with flexibility, including Serbia, are limited by their relatively large FX liabilities.

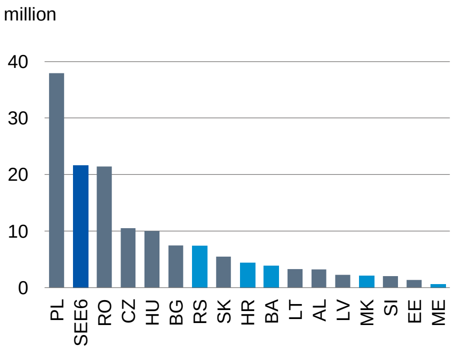
Recent developments in Serbia illustrate how constrained the policy environment is. The new coalition government took office in July and indicated its intention to prioritise growth. But concerns about potential backsliding on fiscal consolidation, and a controversial new central bank law perceived to have reduced its independence, pushed the dinar to new lows. In response, the central bank hiked interest rates and the government pledged to cut the deficit to below 4% of GDP next year and seek a new arrangement with the IMF.

Nominal GDP (2011) 1



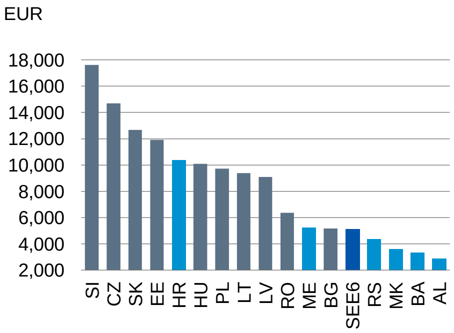
Sources: Eurostat, Haver Analytics, Deutsche Bank

Population (2011) 2



Sources: Eurostat, Haver Analytics, Deutsche Bank

GDP per capita (2011) 3



Sources: Eurostat, Haver Analytics, Deutsche Bank

Introduction

After the breakup of Yugoslavia and the secession wars of the nineties, the Balkan countries have been through a period of significant political and economic transformation and gradual integration into international bodies and institutions. The prospect of joining the European Union has been an important policy anchor, spurring political and economic reforms in the formerly war-torn region. While there has been remarkable progress in several areas, some significant shortcomings remain, in particular regarding the fight against corruption and organized crime but also regarding the international competitiveness of the formerly state-dominated economies.

In this note, we focus on the countries of the Western Balkans: Albania, Bosnia-Herzegovina, Croatia, Kosovo, Macedonia, Montenegro and Serbia.[1] Individually, these countries are small. The largest, Serbia, has a population of just over 7.5 million, whereas the smallest, Montenegro, has a population of just 600,000. They are also relatively poor by European standards, with per capita income levels ranging from EUR 2,868 in Albania to EUR 10,386 in Croatia, or about 11% and 42% of the EU average, respectively (2011 figures). As a group, however, they form a moderately large market. Their population of more than 20 million people is larger than that of the Czech Republic and Hungary. Their combined GDP of EUR 100 billion is roughly the same size as that of Hungary.

Recent economic performance in the region has been mixed. After the export- and credit-driven growth of the first half of the 2000s, the financial crisis that started in late 2008 has found the countries quite differently prepared. Some countries, such as Albania have proven quite resilient to the weakening of international capital flows and reduction in export demand, while others, including Croatia have been harder hit. In very broad terms, the countries that were more open, more integrated with the European economy, and furthest along the road to joining the European Union, tended to suffer the biggest loss in output following the crisis (table).

Less integrated economies fared better in last crisis 4

Countries by region and EU accession status¹	Average GDP growth 2009-10
SEE potential EU candidates (Albania, Bosnia, Serbia)	0.3%
SEE EU candidates (Croatia, Macedonia, Montenegro)	-1.6%
CEE (Bulgaria, Czech Republic, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic, Slovenia)	-3.0%

¹ This refers to countries' EU accession status immediately before and after the global financial crisis. Croatia is now an acceding country and Serbia is now a candidate country.
Sources: Haver Analytics, Deutsche Bank

In the rest of this note, we consider the economic performance and potential of the region in more detail. We start by providing a brief snapshot of each country, highlighting the relative strengths and vulnerabilities. We then focus on the region's economic and financial linkages with their more developed European neighbours with a view to assessing their vulnerability to contagion from the euro crisis. We pay particular attention in this regard to the role of western European banks in the region. Finally, we conclude by reviewing the progress of each country on the road to EU accession.

[1] Together with Slovenia (but excluding Albania), these countries are the successor states to the former Yugoslavia. Slovenia joined the EU in 2004 and is therefore excluded from our analysis. We will also occasionally use the term South Eastern European 6 (SEE6) as a synonym for the Western Balkans. This aggregate includes Albania, Bosnia-Herzegovina, Croatia, Macedonia, Montenegro, and Serbia, but excludes Kosovo due to a lack of data.

Country Snapshots

Albania

Albania	5		
Capital	Tirana		
Population (m)	3.2		
GDP per capita (EUR)	2,868		
Currency	lek		
Ethnic groups (%, 2004)	Albanian 98.6, Greeks 1.2, others 0.2		
	2011	2012F	2013F
GDP (real, % yoy)	2.0	0.5	1.5
Inflation (% yoy)	3.5	2.0	2.8
Current account (% GDP)	-13.3	-13.0	-12.0
Fiscal balance (% GDP)	-3.5	-3.8	-3.6
Public debt (% GDP)	58.9	61.7	62.9

Sources: IMF, national authorities, DoS, Deutsche Bank

Good medium-term growth prospects supported by structural reforms attracted foreign investment, especially in infrastructure and energy; remaining political tensions, very low average income and elevated public debt burden.

Political tensions between government and opposition parties. Since the outcome of the disputed 2009 parliamentary elections, the political landscape of Albania has been defined by its instability. The opposition Socialist Party repeatedly boycotted reforms that are necessary for EU accession. Violent anti-government protests in January 2011 have been followed by renewed tensions around local elections in May. Presidential elections in June 2012 have been boycotted by the opposition and criticised by the EU for not finding a consensus candidate. A recent success has been a reform to the electoral code that found support from both government and opposition.

Crisis resilience and good medium-term growth prospects. Albania is the only European country besides Poland that managed to avoid a recession in 2009. The fallout from the euro area crisis is set to take a temporary toll on the economy, but we should see growth picking up again in the medium term, even though the strong pre-crisis performance (average real GDP growth around 6% from 2000-07) might be out of reach.

Elevated government debt and risk of fiscal slippage. The government cut the fiscal deficit from almost 8% of GDP in 2009 to 3.5% in 2011. However, against a slowdown in economic growth, there is a substantial risk that the 2012/13 fiscal targets of 3% of GDP might be missed. At around 60% of GDP, Albania's public debt is quite large for EM standards and the highest in the region.

Bosnia and Herzegovina

Bosnia and Herzegovina	6		
Capital	Sarajevo		
Population (m)	3.9		
GDP per capita (EUR)	3,318		
Currency	convertible mark		
Ethnic groups (%, 2002)	Bosniak 48.3, Serb 34.0, Croat 15.4, others 2.3		
	2011	2012F	2013F
GDP (real, % yoy)	1.6	0.0	1.1
Inflation (% yoy)	3.7	2.2	2.1
Current account (% GDP)	-8.6	-6.9	-7.0
Fiscal balance (% GDP)	-3.1	-3.8	-2.4
Public debt (% GDP)	40.6	43.4	42.2

Sources: IMF, national authorities, DoS, Deutsche Bank

Ethnic tensions, fiscal constraints and subdued macro outlook; new IMF programme supports the currency board.

Ethnic tensions and political instability hamper reforms. The multi-ethnic country's complex political setup is a major obstacle regarding the institutional and electoral reforms necessary to become an EU membership candidate. It took 16 months after the general elections in October 2010 to form a coalition government due to disputes between the Bosniak and Croat parties. Political stability remains fragile, challenged by disputes within the government and disagreement between the Republika Srpska and the High Representative for Bosnia and Herzegovina about the degree of autonomy to be granted to the Bosnian Serb entity.

New IMF agreement. In July, a new 2-year USD 500 million IMF standby loan was agreed after the new government adopted a budget for 2012. While the previous IMF program had been suspended because of the lack of a government and delays in reforms, the fiscal deficit in 2011 was nevertheless broadly in line with the 3% limit under the programme. There have been minor debt-service delays in Jan 2012. Public debt slightly rose to around 41% of GDP in 2011 and is expected to stabilize below 45% over the next two years.

External imbalances and subdued macro outlook. The current account deficit widened to above 8% of GDP in 2011 and is expected to narrow moderately in 2012 against slowing domestic demand. The deficit is only partly covered by FDI inflows. This contributes to keeping external debt at elevated levels of around 60% of GDP (including a large share of concessional government debt, which is a mitigating factor). With demand from European trading partners slowing, the economy is expected to stall in 2012. Medium-term growth prospects are hampered by slow progress on structural reforms and high unemployment.

Currency board provides monetary stability. The currency board continues to serve as a stabilizing instrument, providing relatively low inflation through a pegged exchange rate with the euro. Foreign exchange reserves remained relatively unchanged at above USD 4 bn (about 45% of M2 at end-2011).

Croatia

EU entry in 2013 to foster medium-term reforms and attract investment; but high external indebtedness and fiscal constraints.

Croatia 7

Capital	Zagreb
Population (m)	4.4
GDP per capita (EUR)	10,386
Currency	kuna
Ethnic groups (%, 2001)	Croat 89.6, Serb 4.5, others 5.9

	2011	2012F	2013F
GDP (real, % yoy)	0.0	-1.2	1.1
Inflation (% yoy)	2.3	3.2	2.5
Current account (% GDP)	-1.0	-1.2	-1.4
Fiscal balance (% GDP)	-5.5	-4.6	-4.7
Public debt (% GDP)	45.6	52.0	55.0

Sources: IMF, national authorities, DoS, Deutsche Bank

Exposure to the euro crisis weighs on the economy. Croatia's strong trade and financial links with the eurozone leave the country exposed to the euro crisis. More than half of total exports go to the currency bloc and almost 20% to recession-hit Italy. The banking sector is foreign-dominated, with Italian parent banks holding almost half of total bank assets. After no growth in 2011, real GDP contracted by 1.3% (yoy) in the first quarter of this year and is expected to decline by 1.2% for the year as a whole on the back of subdued private and public consumption as well as a slowdown in exports and investment.

Risks to fiscal consolidation and rising public debt. The new centre-left government coalition elected in December 2011 has taken steps to consolidate public finances, targeting a fiscal deficit of 3.8% in 2012. The target is based on optimistic growth assumptions and may therefore be missed. Public debt rose to almost 46% of GDP in 2011 and is likely to breach 50% of GDP this year. Further fiscal consolidation and structural reforms to increase the country's competitiveness are necessary to boost growth and ensure the sustainability of public debt.

High external debt and large refinancing needs. External debt has reached around 100% of GDP, although it mainly consists of long-term debt (about 85% of the total), reducing the immediate roll-over risk. The current account deficit has declined significantly since the outbreak of the financial crisis but external financing requirements remain large (above 140% of foreign reserves in 2011), making the country dependent on the commitment of parent banks and other foreign investors.

EU entry set for 2013. Croatia signed the EU accession treaty in December 2011, with entry set for July 2013. A referendum on EU membership in January passed with 66% in favour of joining the EU. The accession treaty still needs to be ratified by all EU member states. Joining the EU would give Croatia access to EU structural and cohesion funds and can be expected to further anchor fiscal policy, foster reforms and spur the inflow of foreign investment.

Banking sector remains stable. So far, foreign parent banks have continued to support their local subsidiaries. Loans are mainly in foreign currency (75%) but to a large extent funded through foreign currency deposits, reducing the dependency on foreign parent banks. NPLs have risen to over 12% at the end of 2011 but stand vis-à-vis a high Tier-1 capital ratio of 17.5%. The banking sector remains profitable and risks stemming from the high FX exposure are mitigated by the central bank's strong commitment to the informal currency peg against the euro.

Macedonia

FYR Macedonia 8

Capital	Skopje
Population (m)	2.1
GDP per capita (EUR)	3,603
Currency	denar
Ethnic groups (%, 2002)	Macedonian 64.2, Albanian 25.2, Turkish 3.9, others 6.7

	2011	2012F	2013F
GDP (real, % yoy)	3.0	1.0	2.5
Inflation (% yoy)	3.9	2.2	2.5
Current account (% GDP)	-2.8	-3.0	-3.2
Fiscal balance (% GDP)	-2.6	-2.7	-2.5
Public debt (% GDP)	28.1	30.5	29.2

Sources: IMF, national authorities, CIA, Deutsche Bank

Manageable government debt levels and IMF programme in support of public finances; EU prospects hampered by unresolved name dispute with Greece.

Moderate public debt but increased reliance on external borrowing. Public debt increased to 28% of GDP in 2011 but is expected to stay at moderate levels. The government missed its deficit target of 2.5% of GDP in 2011 only slightly and is expected to remain close to the target in 2012. Gross external debt increased from 48% of GDP in 2007 to 67% in 2011.

EU ambitions and IMF support serve as policy anchors. Macedonia has been an EU candidate country since 2005. In 2009, the European Commission recommended opening accession talks with Macedonia. However, the decision of EU foreign ministers has been blocked by Greece due to disagreement over Macedonia's constitutional name. A 2-year precautionary IMF arrangement of EUR 476 m was approved in January 2011 and partly (EUR 220 m) used to finance the 2011 budget.

Structural rigidities and widening current account deficit. Macedonia has been recovering from a modest recession in 2009 but structural rigidities, such as weak infrastructure and a poor business climate, persist. The unemployment rate of over 30% remains the highest in the region. The current account deficit is expected to widen slightly to 3% of GDP in 2012 amid a pickup of import demand, though it should largely remain covered by FDI inflows.

Interethnic relations remain difficult. Despite the renewal of the interethnic ruling coalition's mandate in June 2011 which includes the main Albanian political party, relations along ethnic lines (about 64% Macedonian and 25% Albanian) continue to complicate the political situation, highlighted by recent tensions at the beginning of 2012.

Montenegro

Montenegro 9

Capital	Podgorica
Population (m)	0.6
GDP per capita (EUR)	5,256
Currency	euro (de facto currency)
Ethnic groups (%, 2003)	Montenegrin 43, Serb 32, Bosniak 8, Albanian 5, others 12

	2011	2012F	2013F
GDP (real, % yoy)	2.5	0.4	1.5
Inflation (% yoy)	3.1	2.5	2.5
Current account (% GDP)	-19.4	-19.7	-20.0
Fiscal balance (% GDP)	-6.5	-5.0	-4.5
Public debt (% GDP)	45.8	49.5	50.5

Sources: IMF, national authorities, CIA, Deutsche Bank

Rising public debt and persistent external imbalances; undiversified economy vulnerable to external shocks; launch of EU accession negotiations to strengthen reform process.

Deteriorating public finances. The fiscal deficit swelled to above 6% of GDP in 2011 against a decrease of the revenue base but also reflecting the materialisation of contingent liabilities from Montenegro's bankrupt steel mill. The government also gave a loan guarantee of around 4% of GDP to a troubled aluminium plant, which has already been partly triggered. The deficit should fall in 2012 and 2013 but remain large at around 5% and 4.5% of GDP, respectively. Public debt rose significantly from below 30% of GDP in 2007 to above 45% in 2011 and is expected to move towards 50% over the next two years.

External imbalances. The current account deficit declined from above 50% of GDP in 2008 but is expected to remain large at around 20% in 2012/13. A large share of the deficit is covered by net FDI, but vulnerability to external sentiment nevertheless remains high. External debt is sizable at around 100% of GDP.

Undiversified economy affected by eurozone crisis. The economy is heavily dependent on aluminium exports and tourism. This makes the country vulnerable to external shocks. GDP growth is expected to slow to below 0.5% in 2012 and strengthen only slowly to around 1-2% in 2013. High unemployment (close to 20%) reflects the need for labour market reforms.

EU accession procedure anchors reforms. The EU started accession negotiations with Montenegro in June 2012. While it will take several years for Montenegro to become an EU member, the process will provide a strong impetus for reforms. However, shortcomings in some areas, in particular regarding the fight against corruption and organized crime remain large.

Use of euro as legal tender. The unilateral introduction of the German mark in 1999 and subsequently of the euro in 2002 has helped to reduce inflation and to stabilize the monetary system.

Serbia

Serbia 10

Capital	Belgrade		
Population (m)	7.4		
GDP per capita (EUR)	4,368		
Currency	dinar		
Ethnic groups (%, 2002)	Serb 82.9, Hungarian 3.9, Bosniak 1.8, Romany 1.4, others 10		
	2011	2012F	2013F
GDP (real, % yoy)	1.6	-0.6	1.7
Inflation (% yoy)	11.2	5.5	5.0
Current account (% GDP)	-9.1	-8.5	-8.2
Fiscal balance (% GDP)	-4.0	-6.5	-4.5
Public debt (% GDP)	47.9	54.0	53.0

Sources: IMF, national authorities, CIA, Deutsche Bank

Start of EU accession negotiations and access to IMF financial assistance hampered by controversy over new central bank law; fiscal deficit to overshoot 2012 target significantly; large current account deficit.

Exposure to eurozone crisis through trade and financial linkages. More than 40% of Serbia's exports go to the currency union. Eurozone parent banks also control more than 70% of the Serbian banking system. Parent banks are generally expected to maintain their exposure but increased capital requirements and a refocusing on parent banks' key markets is likely to limit new lending. Exposure to Greek banks remains a risk factor. The economy shrank by 1.3% (yoy) in the first quarter of 2012 and is expected to decline by 0.6% over the whole year.

Large current account deficit and external debt burden. After narrowing significantly since 2008, the current account deficit widened again in 2011 to above 9% of GDP, driven by an increase in imports. Gross external debt has fallen but remains around 80% of GDP (end-2011). However, roll-over risks are mitigated by the high share of long-term debt (around 95%) with an average maturity of over 7 years. At the same time, external financing requirements have been reduced from significantly above 100% of foreign reserves before 2009 to 85% in 2011.

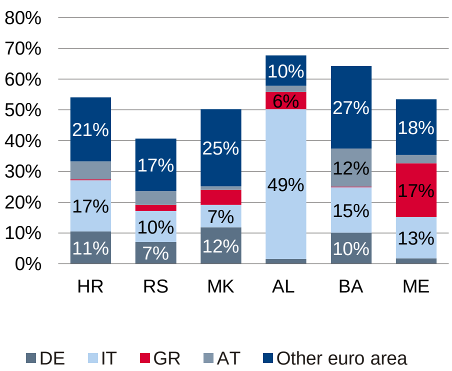
Risk of fiscal slippage. The 2012 budget aims at reducing the fiscal deficit to 4.25% of GDP. However, the Finance Ministry admitted that the 2012 deficit might come in as high as 7% of GDP but that it aimed to cut it to below 4% of GDP in 2013. Public debt is relatively moderate at around 50% of GDP but is rising (and has already breached the legal limit of 45% of GDP introduced only last year).

New central bank law jeopardizes IMF support. In a controversial move, the new Socialist-led government, which took office almost three months after the May parliamentary elections, changed the central bank law in August. The amendment, which gives the parliament supervisory power over the central bank's executive board and the responsibility to appoint the central bank council members, received strong criticism from the EU and the IMF for reducing the central bank's independence and led to the resignation of the central bank governor and other members of the council. This will complicate the government's efforts to re-engage with the IMF.

Granting of EU candidate status. Serbia was granted EU candidate status in March 2012 after progress in negotiations with Kosovo. Accession negotiations could be opened in early 2013 but might be hampered by recent disputes over the new central bank law. In any case, the road to full EU membership will likely be a long one given signs of enlargement fatigue within the EU and the broad reform agenda needed to align Serbia's institutions and legal frameworks with EU standards. The status of Kosovo will also remain a major issue. But overall, an increased pace of reforms towards EU membership can be expected to boost growth potential and attract foreign investment in the medium term.

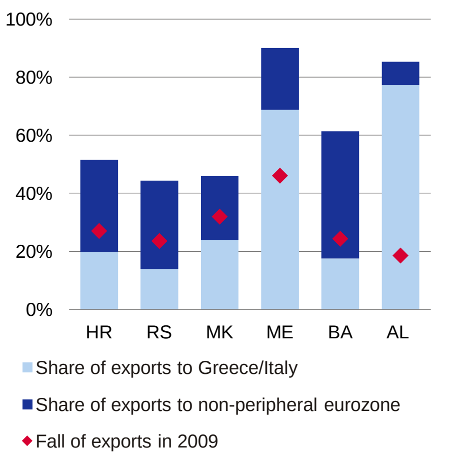
Exports to euro area 11

% of total exports, 2011



Sources: IMF DOTS, Deutsche Bank

Post-crisis decline in exports 12



Sources: IMF DOTS, Haver Analytics, Deutsche Bank

Contagion from the euro crisis

Given their geographical location and limited size, the vulnerability of the Western Balkan countries to the euro crisis is self evident. Two of their largest economic neighbours, Greece and Italy, are among the countries that have been most badly affected by the euro crisis. Negative spillovers to the region are therefore inevitable. We assess these vulnerabilities, focusing on various channels of contagion, including trade, investment, and remittances. We pay particular attention to the role of European banks in the region, which played an important role in financing the extension of credit prior to the last crisis but which are now under pressure to strengthen their balance sheets and reduce their degree of leverage. We also assess the scope for easier macroeconomic policies should contagion from the euro area threaten to tip the region's economies into recession.

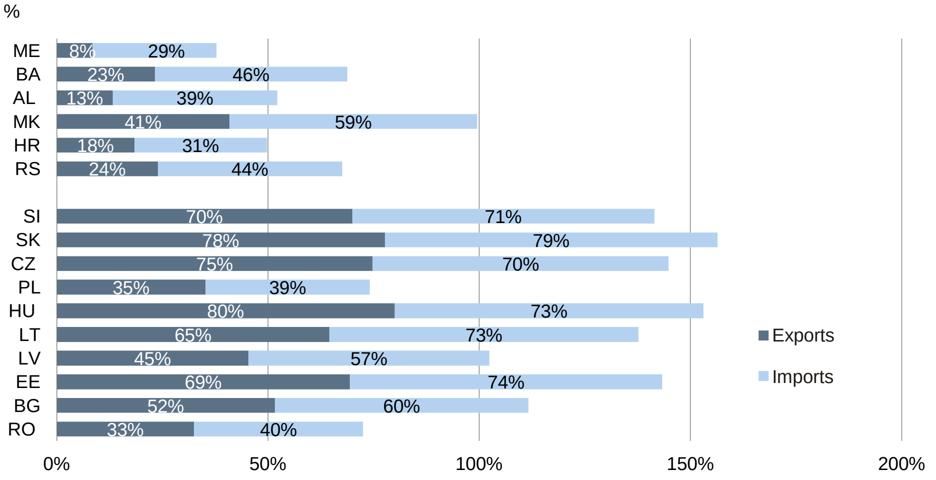
Trade

The euro area is the main trading partner for the region, accounting for about half of all exports on average, though somewhat more than this for Albania and Bosnia-Herzegovina and slightly less than this in the case of Serbia, which has relatively strong trade links with Russia and other emerging European economies. Within the euro area, Italy is generally the most important export market for the region, especially for Albania. Greece is much less important on average, though it is the largest single export market for Montenegro. Trade linkages with the rest of the euro area are mostly dominated by Germany with the other peripheral countries of marginal importance.

This geographical composition of trade largely determined the relative export performance within the region following the Lehman crisis. Countries with relatively greater exposure to the Italian and Greek markets suffered the largest declines in their exports in 2009. Albania was a notable exception, with exports holding up relatively well despite its heavy dependence on the Italian market.

Importantly, however, the Western Balkan countries are less reliant on exports than other emerging European economies. For instance, the share of exports in GDP is about 60% on average in Central and Eastern Europe (CEE) but only 21% in the Western Balkans (chart). So while the euro area, and Italy and Greece in particular, are important markets for the region, their importance in relation to GDP should not be exaggerated. Exports to the euro area account for over 20% of GDP only in Macedonia, the most open economy in the region, but less than 10% of GDP in Albania, Croatia, Montenegro, and Serbia. Moreover, exports to the struggling Italian and Greek markets are less than 5% of GDP on average for the region. This partly explains why the region typically experienced a shallower recession than their more open CEE neighbours following the Lehman crisis when global trade flows collapsed (see earlier table).

Exports and imports as share of GDP (2011) 13



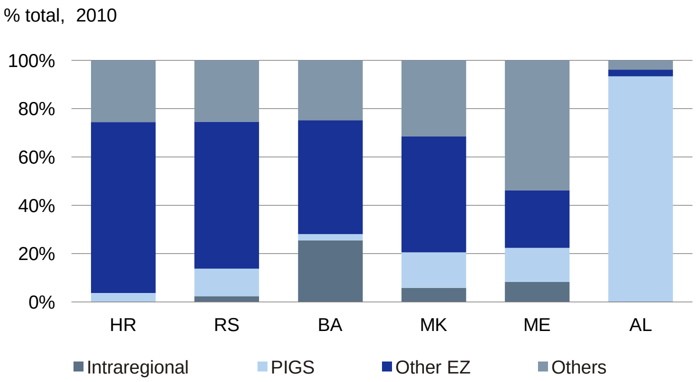
Sources: Haver Analytics, Deutsche Bank

Investment

With relatively low labour costs and easy access to European markets, the region has attracted significant direct investment in recent years. Most of this investment has come from Europe, with the euro area accounting for about 70% of the total stock of inward direct investment in the region. Italy is a major investor within the region, especially in Albania where it accounts for 80% of the total (consistent with the strong trade links between the two countries) but also in Montenegro. Greece also has significant investments in Albania, Macedonia, and Serbia.

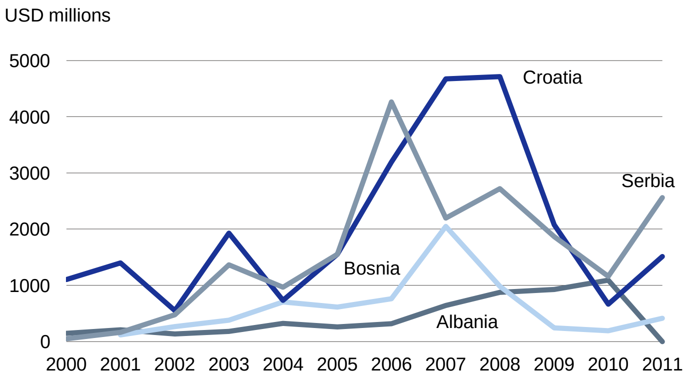
As in other emerging European economies, direct investment in the region generally peaked a year or two prior to the Lehman crisis and then fell sharply. Inward investment flows have begun to recover but remain below their pre-crisis peak levels.

Stock of inward FDI by source 14



Sources: IMF Coordinated Direct Investment Survey, Deutsche Bank

Net FDI flows 15

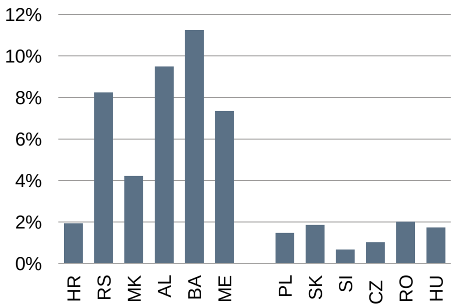


Sources: Haver Analytics, Deutsche Bank

Remittances

Remittances 16

% of GDP, 2011



Sources: World Bank, Deutsche Bank

Remittances are an important source of income and financing for the balance of payments for much of the region. Annual remittance flows account for about 9% of GDP on average in Serbia, Albania, Bosnia-Herzegovina and Montenegro. They are somewhat less important for Croatia and Macedonia (about 3% of GDP), which are more similar to the CEE region in this regard.

While it is difficult to get accurate data on the source of these flows, recent estimates from the World Bank based on the migrant stocks and income levels can provide us with a rough picture.[2] They suggest that Germany is a major source of remittance flows to the region, particularly for Croatia, Macedonia, and Bosnia-Herzegovina. Austria is a particularly important source of remittance flows to Serbia. Among the peripheral euro area countries, most remittance flows to Albania come from Greece and Italy with the latter also an important source of flows for Macedonia.

Whether or not remittances are a source of risk (e.g. leaving recipient countries vulnerable to recessions in source countries like Greece and Italy) or a stabilizing factor is unclear. They are likely to be affected by a range of push and pull factors depending on conditions in the source and recipient countries. The recent pattern of remittance flows in the region is similarly inconclusive but does not seem to have been a big factor either way. Remittance flows to Albania and Bosnia-Herzegovina, for example, fell significantly in 2009 and 2010 while flows to Serbia have increased over the same period.

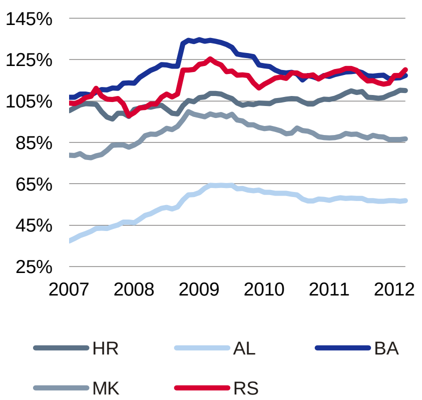
Remittances by source 17

% of total, 2010	Albania	Bosnia and Herzegovina	Croatia	Macedonia	Serbia
Greece	47%	0%	0%	0%	0%
Italy	38%	3%	4%	22%	0%
France	0%	1%	4%	2%	11%
Germany	1%	19%	48%	23%	0%
United States	7%	9%	6%	2%	18%
Austria	0%	13%	7%	5%	68%
Intra-region	4%	30%	1%	3%	2%
Other EZ	0%	6%	4%	4%	0%
Other EU	1%	14%	7%	21%	0%
Other	2%	6%	18%	17%	0%

Sources: World Bank, Deutsche Bank

Loan-to-deposit ratios stabilize 18

%



Sources: IMF IFS, Deutsche Bank

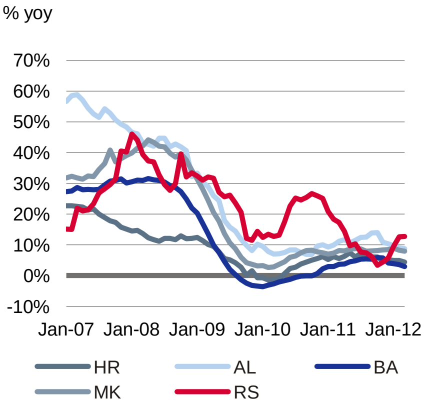
Foreign bank ownership

Foreign (European) banks have developed a strong presence in the region, accounting for about 75-90% of banking system assets of the region. This level of foreign ownership is broadly similar (a touch higher) to that seen in the CEE region. But the ownership structure is a little more concentrated by country compared with the more diverse foreign ownership of CEE banks. Italian and Austrian banks, for example, are dominant in Croatia; Greek, Italian, and Austrian banks are the major players in Serbia; and Dutch and Greek banks in Macedonia.

Prior to the financial crisis, it was generally thought that the significant presence of foreign banks was a good thing. Aside from bringing microeconomic benefits such as managerial know how, it was thought that foreign banks would also support financial stability as larger and more liquid foreign parent banks could

[2] Montenegro is excluded from the estimates due to a lack of data.

Private sector credit growth is subdued 19



Sources: IMF, Deutsche Bank

help to smooth out domestic funding shortfalls. However, it has also become clear that funding shocks to foreign parent banks can be transmitted to their subsidiaries, with potentially damaging implications for local lending.

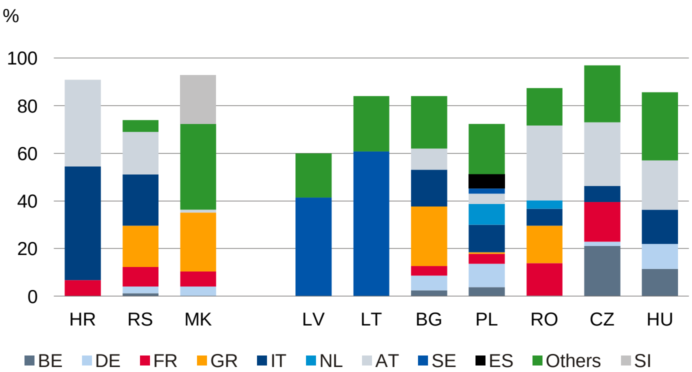
There are two possible scenarios how this latter risk may manifest itself: first, a moderate shift from foreign to local funding and gradual deleveraging; or second, a wave of exits and disorderly deleveraging.

The first scenario has already been happening. Prior to 2007, foreign borrowing contributed strongly to the growth of credit. But the strength of this contribution had already started to slow well in advance of the crisis. Together with the slowdown in deposit growth which came a bit later as domestic economies in the region began to slow, this has resulted in subdued credit growth. Since 2009, banks have been shifting towards local funding, as reflected in a gradual fall in their loan-to-deposit ratios.

Still, loan-to-deposit ratios are above 105% in Serbia, Croatia and Bosnia-Herzegovina and above early-2007 level for all the countries. Therefore, there is still some space for further deleveraging, though perhaps less so in Macedonia and Albania, where loan-to-deposit ratios are already relatively low. The recapitalization of European banks that is now undergoing may contribute to this trend. Hence, it would be reasonable to expect that gradual deleveraging would continue and credit growth will remain subdued and constrained mainly by the pace of domestic deposit growth.

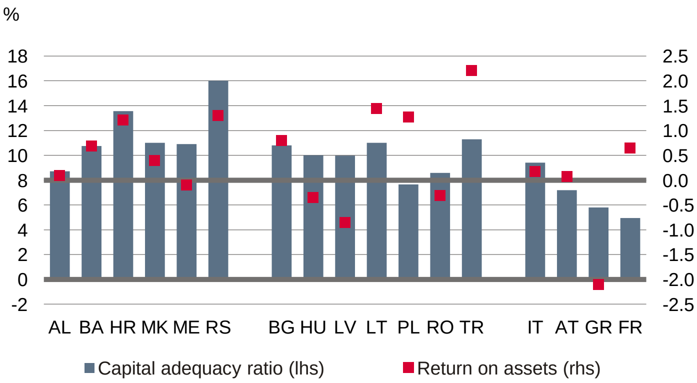
While there is certainly a risk that we could see more rapid and less controlled deleveraging by European banks, we think this is less likely for several reasons. First, notwithstanding an increase in the level of non-performing loans following the crisis, banking sectors in the region are in relatively good shape (well capitalized and profitable), especially in Croatia and Serbia, so holding on to these portfolios should still be attractive for foreign banks. Second, local portfolios are small relatively to the size of foreign parent banks (i.e. selling them will make only a small contribution to the broader deleveraging process). Third, even where asset sales are being contemplated, it is likely to be difficult in this environment for foreign parents to find buyers for their local subsidiaries.[3] And finally, the Vienna coordination initiative may at the margin help to ensure that European banks avoid uncontrolled deleveraging beyond their borders.

Foreign bank ownership of banking system assets 20



Sources: Fitch Ratings, Deutsche Bank

Bank profitability and capital adequacy 21



Sources: IMF, Deutsche Bank

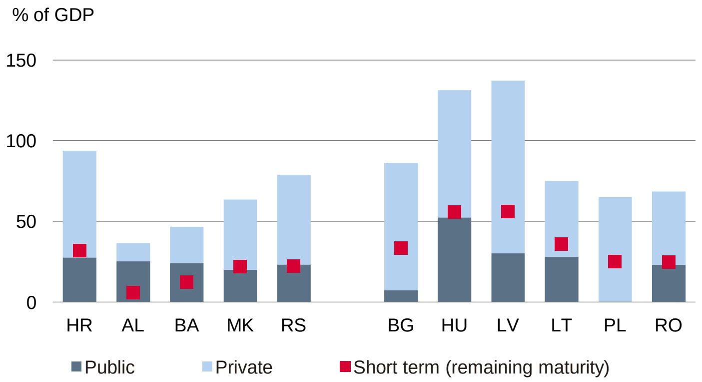
3 Recent sales of banks in emerging Europe have been few and far between in the last couple of years.

Indirect channels of contagion: Debt markets

Aside from these direct channels of contagion through the region's economic and financial linkages with the euro area, countries may also be exposed to contagion from the euro crisis through indirect channels. Large stocks of debt can leave countries vulnerable to increased risk aversion and reductions in international capital flows on several fronts: (i) rollover risk, especially if the stock of external debt is large and/or a high proportion of it is held at short maturities; (ii) currency risk on debt that is denominated in foreign rather than domestic currency; and (iii) interest rate risk, to the extent that borrowing costs are correlated with spikes in borrowing costs in peripheral Europe. The picture on this front is somewhat mixed both within the region and when compared to CEE countries.

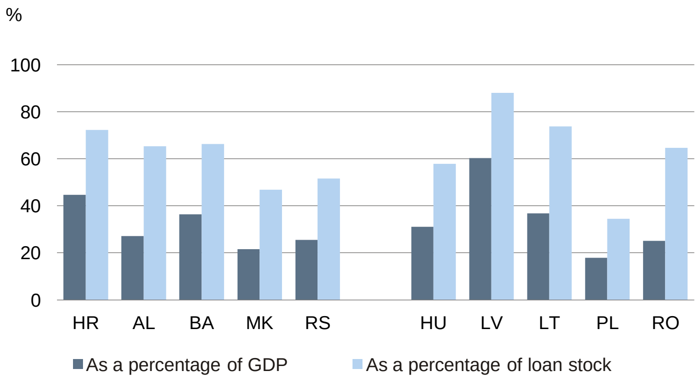
With the exceptions of Albania and Bosnia-Herzegovina, persistent current account deficits have resulted in relatively high levels of external debt, especially in Croatia, Macedonia, and Serbia. This is similar to debt levels in most of the CEE region (excluding Hungary and Latvia where external debt is exceptionally high). A relatively smaller proportion of this debt, however, is held at short maturities (partly a reflection of the provision of longer-term support by the official sector to support political and economic transition) and rollover risks are correspondingly lower.

External debt levels (2011) 22



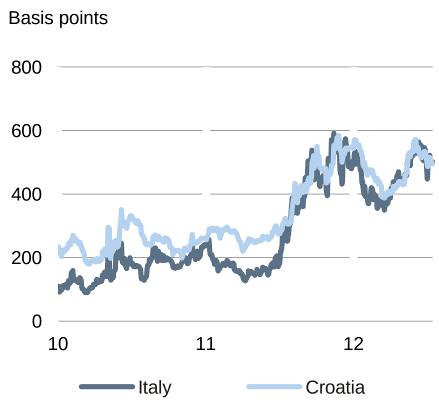
Sources: EBRD, Deutsche Bank

FX-denominated loans to private sector (2011) 23



Sources: EBRD, Deutsche Bank

Italian and Croatian CDS Spreads 24



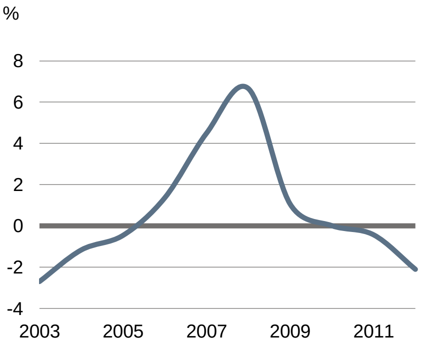
Sources: Bloomberg LLP, Deutsche Bank

The proportion of FX-denominated loans is also high, constituting more than 50% of total loans to the private sector in the region and over 70% of loans in Albania, Bosnia-Herzegovina, and Croatia. This leaves these countries vulnerable to currency depreciation. One can argue that these risks are low in Macedonia, Bosnia-Herzegovina and Croatia, which have successfully pegged their currencies to the euro for more than 10 years. However, recent experience in Latvia underscores that these pressures can manifest themselves in different ways. Faced with external pressures but worried about the damaging impact on balance sheets of devaluation, Latvia elected to pursue much tighter macroeconomic policies in order to sustain its exchange rate peg, resulting in a sharp contraction in domestic economic activity (i.e. internal devaluation).

Finally, there are also some signs of that stress in the euro area is also pushing borrowing costs in the region. For example, credit default swap (CDS) spreads for Croatia have moved closely in line with Italian CDS spreads recently (chart). Government borrowing costs in the region more broadly have also tended to rise and fall as euro area related stresses have waxed and waned.

Scope for policy response

Output gap in the Western Balkan region 25



Average for Albania, Croatia, Macedonia, Bosnia-Herzegovina, Montenegro, and Serbia

Sources: Haver Analytics, IMF, Deutsche Bank

Like many other countries in emerging Europe, the Western Balkan countries entered the last global financial crisis at the peak of their economic cycles. Output was about 6-7 percentage points above potential on average in the region in 2007-08 (chart), inflation was relatively high, and current account deficits were large. They were, therefore, highly vulnerable to the ensuing external shock.

The current situation is different. Output is likely to fall further below potential this year, inflation has decelerated, and current account deficits have fallen (though they remain high except in Croatia and Macedonia). Another external shock may therefore have a less damaging effect on output this time around.

On the other hand, the scope for policy easing to counteract the impact of an external shock is more limited now. During the last crisis, policymakers were to some extent able to soften the blow by allowing fiscal deficits to widen, supported in some cases (Serbia and Bosnia-Herzegovina) by official external support. The fiscal balance widened from close to balance on average for the region in 2007 to a deficit of about 5% of GDP in 2009.

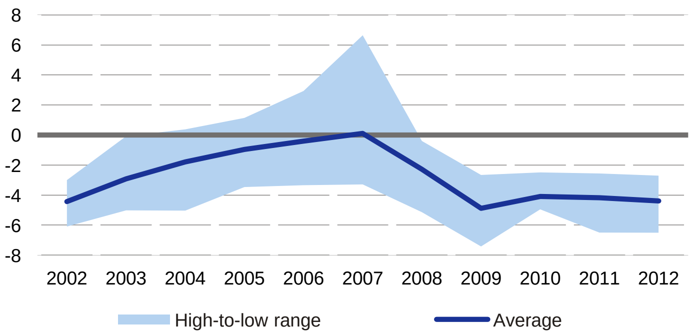
But this policy space has not yet been rebuilt. Weak growth has hit government revenues and budget deficits are set to remain over 4% of GDP on average this year, with a notable deterioration in Serbia where the deficit is likely to exceed 6% of GDP this year. Government debt levels have therefore risen from a relatively moderate 34% of GDP on average prior to the crisis. We estimate that this will increase to 48% of GDP by the end of this year. Faced with this backdrop, the emphasis on most countries in the region is on fiscal consolidation, with Macedonia probably the only country that has some space to ease fiscal policy (or at least limit the pace of fiscal consolidation) if necessary.

The room for manoeuvre regarding monetary and exchange rate policies is, if anything, even more limited. Most countries in the region have pegged their currencies either formally or informally to the euro. Serbia and Albania do run flexible exchange rate regimes but their discretion is also constrained by their still relatively large liabilities denominated in foreign currencies.

Recent developments in Serbia illustrate how constrained the policy environment is. The new coalition government took office in July and indicated its intention to prioritize growth. But market concerns about potential backsliding on fiscal consolidation, and a controversial new central bank law perceived to have reduced its independence, pushed the dinar to new lows. In response, the central bank hiked interest rates and the government pledged to cut the deficit to below 4% of GDP next year and seek a new arrangement with the IMF.

Fiscal balances have not yet recovered 26

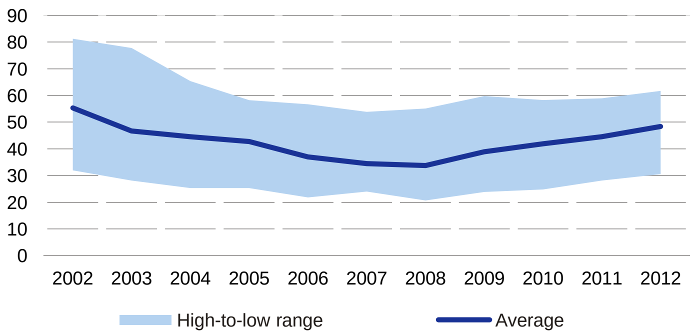
Fiscal balance (% of GDP)



Sources: IMF, Deutsche Bank

Public debt levels on the rise 27

Public debt (% of GDP)

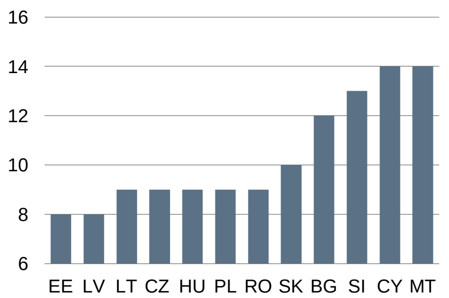


Sources: IMF, Deutsche Bank

The road to EU accession

EU accession "application periods" 28

Number of years taken to accede



Note: all new member states joined the EU in 2004 (except for Bulgaria and Romania in 2007)

Source: Deutsche Bank

Officially, all countries in the Western Balkans are invited to join the EU once they have fulfilled the membership requirements, most importantly the Copenhagen criteria.[4] These criteria include compliance with democratic standards, rule of law, human rights and a functioning market economy.

During previous enlargement rounds, it took the new member countries at least eight years (Estonia and Latvia) and up to 14 years (Cyprus and Malta) from first applying for membership and final accession to the union. The average "application period" has been around 10 years. In recent years, however, and particularly in the course of the ongoing crisis in the euro area, one can observe a certain "enlargement fatigue" in the EU. For most countries in the Western Balkans, therefore, EU accession before the middle of this decade seems highly unlikely. Given the multiple political obstacles in the region and the need for reforms in many key areas, the EU aspirations of many countries might not be fulfilled before the end of the decade. The current status for each of the Western Balkan countries is summarized below:

— Croatia is the only country in the Western Balkans for which an accession date has been set already. It is expected to join the EU in July 2013 as its 28th member. Croatia applied for membership already in 2003 and started accession negotiations in 2005. After completion of the negotiations in June 2011, the accession treaty now still needs to be ratified by all EU member states.

— Serbia officially applied to the EU at the end of 2009 and has been granted candidate status in March 2012, supported by the arrest and extradition of suspected war criminal Ratko Mladić to the International Criminal Tribunal in The Hague and political progress regarding the relationships with Kosovo. Under the previous government, Serbia has been hoping to start accession negotiations at the beginning of 2013, but given the discontent within the EU about recent political developments in Serbia (reduction of central bank independence), delays in setting a starting date for negotiations cannot be excluded.

— Macedonia has been an EU candidate since 2005 (application in 2004), when the European Commission recommended that the EU should open accession negotiations with the country. However, so far a starting date to open negotiations has not been set. Macedonia's EU ambitions continue to be locked due to a dispute with Greece, which is concerned that the use of "Macedonia" as the country's official name would imply a territorial claim on a province of the same name in the north of Greece.[5] As an EU member, Greece can use its veto right to block Macedonia's accession.

— Montenegro applied for EU membership in 2008 and started accession negotiations in 2012. However, there are several open issues (corruption, fight against organized crime) on the way towards accession.

— Albania applied for EU membership in 2009, but its application has been rejected due to shortcomings regarding the strengthening of democratic institutions and rule of law, the fight against corruption and organized crime. A Stabilisation and Association Agreement (SAA) between the EU and Albania – which is a prerequisite for being granted candidate status – exists since June 2006. Recent reforms to the electoral code should have a positive impact on Albania's prospects to achieve candidate status this year.

[4] For details of the accession process, see: http://ec.europa.eu/enlargement/index_en.htm
[5] The EU (and other international bodies) recognizes the country under the provisional name "Former Yugoslav Republic of Macedonia" (FYROM).

— Bosnia and Herzegovina signed an SAA with the EU in 2008, after the EU expressed its satisfaction with the progress made regarding institutional reforms. It is questionable, whether the unstable political situation in the multi-ethnic state, which is divided in two autonomous entities and supervised by an international High Representative, will allow the adoption of constitutional reforms necessary for a successful application for EU candidate status already in 2012. Concerns about ethnic tensions, organised crime and corruption will remain long-term obstacles to EU accession.

— Kosovo. The EU considers Kosovo as a potential candidate, underlining that Kosovo "has a clear European perspective in line with the European perspective of the Western Balkans region" (European Commission, 2012).[6]

EU financial assistance available (2007-13) 29

Country	EUR m
Albania	597
Bosnia and Herzegovina	659
Croatia	1,000
Macedonia (FYR)	619
Montenegro	237
Serbia	1,392
Kosovo	638
Total	5,141

EU financial aid under the instrument for pre-accession assistance (IPA) for 2007-13
Sources: European Commission, Deutsche Bank

EU Accession Status 30

Country	Status	Progress
Albania	Potential candidate	Applied for EU membership in 2009
Bosnia and Herzegovina	Potential candidate	
Croatia	Acceding country	Accession scheduled for July 2013
Kosovo	Potential candidate	
Macedonia	Candidate country (since 2005)	Accession blocked by name dispute with Greece
Montenegro	Candidate country (since 2012)	Accession negotiations started in June 2012
Serbia	Candidate country (since 2012)	Date to start accession negotiations not yet decided

Source: European Commission, Deutsche Bank

Despite the expected positive impact on trade flows, investment and other advantages from becoming part of the European single market, the access to funds from the EU budget is an important financial incentive for the Western Balkan countries to join the EU. After joining the EU, each country’s annual net receipts from the EU budget will depend on several factors, including the country’s gross national income. However, looking at net contributions to the EU budget in 2009 shows that all Central and Eastern European countries that joined the EU in 2004 and 2007 have been net recipients, ranging in absolute terms from EUR 240 million in Slovenia to EUR 6.3 billion in Poland, or relative to economic size from 0.7% of GDP in Slovenia to 5.4% of GDP in Lithuania (see Talking Point EU net contributor or net recipient: just a matter of your standpoint? May 18, 2011).

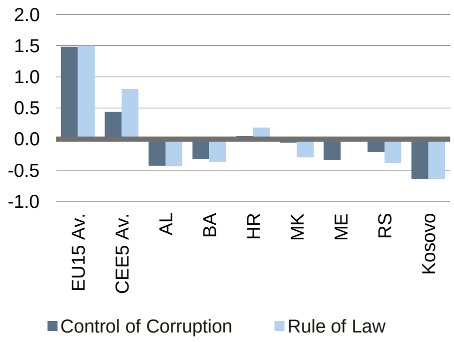
As first country in the region, Croatia will have access to the European funds upon joining the EU in July 2013. For the second half of 2013, the total funds from the EU will be EUR 688 million. Croatia’s contributions to the EU will be around EUR 268 million. Croatia’s net receipts will thus amount to EUR 420 million or about 0.8% of GDP. Its net receipts thereafter will be determined in the context of the EU’s Multiannual Financial Framework for 2014-20.

Candidates and potential candidates also qualify for financial support from the EU to help them fulfil the requirements of accession. Over EUR 5 billion of

[6] The EU uses the notation Kosovo*, with the asterisks reading as: “This designation is without prejudice to positions on status, and is in line with UNSCR 1244 and the ICJ Opinion on the Kosovo declaration of independence.”

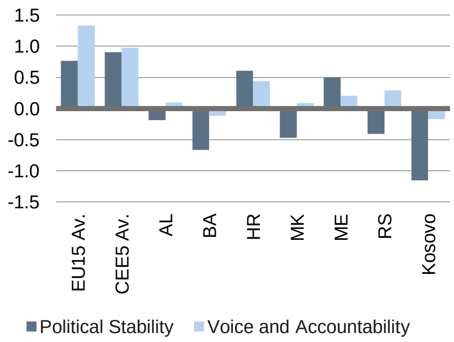
Western Balkans: Bumps on the road to EU accession

Corruption and the rule of law 31



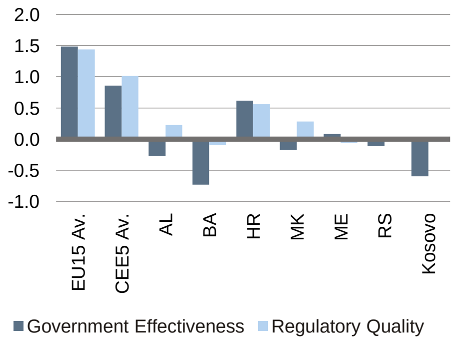
Sources: World Bank, Deutsche Bank

Political stability and voice/accountability 32



Sources: World Bank, Deutsche Bank

Government effectiveness and regulatory quality 33



Sources: World Bank, Deutsche Bank

financial support from the EU was assigned in support of the Western Balkans for the period 2007-2013 (table).

While the process of consolidating democracy and establishing pluralistic societies in the Western Balkan countries has been impressive, significant shortcomings remain in meeting EU requirements regarding good governance and democratic standards. This can be seen from comparisons between the Western Balkans and the EU of the World Bank's Governance Indicators. The charts on the left show six indicators covering voice and accountability, political stability, government effectiveness, regulatory quality, rule of law and control of corruption.[7] In all cases, the indicators for the Western Balkans are weaker than the average for the EU (EU-15) and Central European (CEE-5) countries, though the gap is notably less pronounced in the case of Croatia.

As has been shown, political progress in the region has been significant, but more has to be done to integrate, after Croatia, the rest of the Western Balkans into the EU. The political shortcomings and democratic deficits illustrated above are amplified by the internal and external disputes within the region. Both Serbia and Kosovo remain adamant regarding their position about an independent Kosovarian state; the political stability in Bosnia and Herzegovina is continuously challenged by its multi-ethnic setup and secessionist rhetoric in the Republika Srpska, the Bosnian Serb entity; despite some recent success in electoral reforms, relations between the government and the opposition in Albania continue to hamper the political process; the name dispute between Macedonia and Greece remains unresolved.

Faced with these challenges, rapid accession is likely to be difficult. Nevertheless, the prospect of European integration, even if still relatively remote for some countries, can be considered as one of the main drivers for reforms and strengthening of political stability in the region. From the European perspective, the integration of the Western Balkans therefore represents itself as a delicate balance between the risk of granting accession too hastily and before the countries are actually ready to comply with European standards on one hand, and the risk of damaging the democratic achievements in the Balkan region by continuously holding countries back in their EU ambitions (see Balfour and Stratulat, 2011: "The democratic transformation of the Balkans"; European Policy Centre).

The authors would like to acknowledge the invaluable assistance of Mark Ozerov.

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[7] Indicators are on a scale from approx. -2.5 to +2.5, with mean at zero (world average) and higher values corresponding to better governance.

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