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Financial Crisis Effect on Public Debt in Western Balkans Countries

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The end of the first decade of the twenty-first century will be remembered by appearance of one of the greatest economic crisis. This time, it had a global character. The crisis has been appeared, almost unexpectedly, in the middle of 2007 in the US, but very soon it was transferred to other countries in the world as well. Very likely, it will last durably, with wide devastating consequences.

The current economic crisis has made the existing unfavorable situation more complex and deepened the present imbalances and risks. The economic and financial crisis led to a strong increase in the public debt in the euro area countries, the United Kingdom, the United States and Japan. Moreover, without a change of policy, the public debt will continue to expand in most of developing countries such as Albania.

Public debt challenges are a major recurring concern across the globe. Today many countries face the prospect of high and unsustainable public debt levels amid a weak economic recovery caused by the global financial crisis that started in 2007. The impact of the crisis on public debt was immediate, severe and with potential long-lasting negative effects due to its housing roots and global reach. The basic aim of this article is to consider the effect of the current financial crisis on the movements and sustainability of the public debt in the period up to 2013.

The paper will try to analyze also the effects that public debt has on the economic growth through the examination of the main data used in this *study. The results are consistent with the existing literature that has found a negative correlation between public debt and economic growth.*

Keywords: *Public debt, financial crisis, economic growth*

Introduction

The global financial crisis, which originated in the advanced economies, has hit the rest of the world strongly, with some developing countries being particularly affected. However, the impact on economic activity has varied widely across countries. The economic and financial crisis led to a strong increase in the public debt in the euro area countries, the United Kingdom, the United States and Japan. Moreover, without a change of policy, the public debt will continue to expand in most of those countries.

This article describes the impact of the financial and economic crisis on the public debt level and the possible consequences and inherent risks of this situation. Those risks have also been illustrated by the problems which certain euro area countries have recently experienced in financing their public debt on the financial markets: those countries had to resort to the conditional financial assistance of the IMF and other European countries. A return to sustainable

Public finances, not only in those countries but also in most of the other advanced economies, will require a sustained consolidation effort in the coming years. It is very well known that growth rates play a role in debt dynamics. Despite this widespread knowledge, real world narratives of public debt crises often focus almost exclusively on budget deficits and neglect the role of growth.

The Crisis and its Impact on Regional Economies

The nature of the beginning global financial crisis in the United States and developed economies of Western Europe did not share similar characteristics with its appearance in the Western Balkans and Albania. As developed economies faced systemic problems in their banking systems that then spilled over in to the real economy, the financial sectors in the Western Balkans and Albania remained largely insulated due to a lessened degree of exposure. Banks and financial institutions in the region have not been as active in the international financial arena, and the countries' stock markets do not match the size of their counterparts in more developed countries. However, the crisis has not completely bypassed the region. The transmission effects, the speed, and the depth of the crisis took hold in various ways, owing in part to the heterogeneity of regional economic structures. Many of the crisis effects arrived through decreases in domestic demand and consumption, as a result of the tightening of available credit in the region, constricting the domestic demand which served as one of the principal factors in regional growth in recent years. Coupled with these shocks of tightened credit markets and decreased consumption, the Western Balkans and Albania have been negatively impacted by downturns in many of the productive sectors of their real economies, through slumping trade and investment partners in Western Europe. This along with downturns in important commodities such as metals has negatively affected industrial production, and export performance has weakened considerably in several sectors. These factors have contributed considerably to the declines in GDP growth experienced by many countries in the region in 2009.

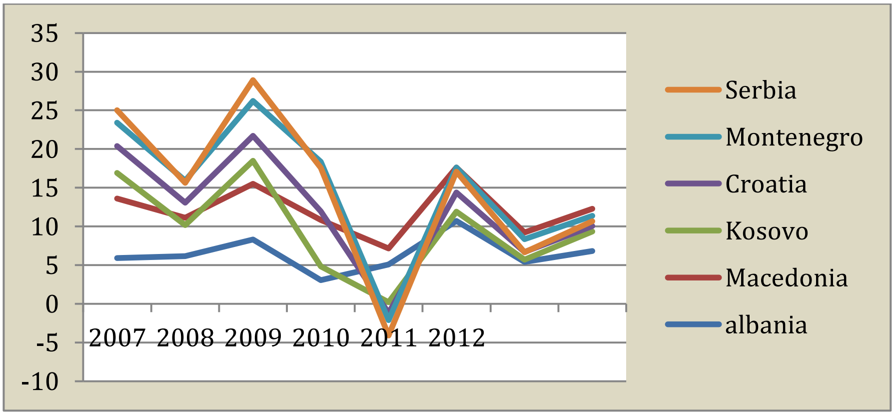

Figure 1: GDP growth rate trend in Western Balkans

Source: World Bank 2013

A key factor in determining the timing and strength of the crisis has shown to depend on the degree of integration a country has to markets in the EU, the significance of economic and financial relations with the EU within their economies, as well as similarity in the structures of the economies with Europe. Croatia, which of all countries in the region has one of the most similar profiles to the EU-12 economies, is where some of the first signs of economic difficulties were seen. Croatian third quarter 2008 year-on-year GDP growth registered at 1.6 per cent, was barely positive at 0.2 per cent for the fourth quarter, before sinking further and contracting through the first three quarters of 2009, by 6.7, 6.3, and 6.7 per cent, respectively. Serbian economic performance declined similarly. While GDP growth there for 2008 ended at a respectable 5.5 per cent, it was however marked by constantly decreasing quarterly GDP growth rates, beginning with 9.5 per cent in the first quarter of the year and ended with 0.4 per cent growth in the fourth quarter. January through September of 2009 witnessed a contraction of 3.6 per cent, with Serbia's Republican Statistical Office estimating that 2009 overall featured a GDP contraction of 2.3 per cent, suggesting some pickup in economic performance for the fourth quarter of the year. Real GDP growth rates in Montenegro contracted by 4 per cent in the first three quarters of 2009.

Reduced degrees of integration in to Euro zone economies, such as in Albania and to a lesser extent Bosnia and Herzegovina, has allowed for greater levels of GDP expansion in these economies. Despite this, growth in 2009 has slowed throughout the progression of the year, when examining year-on-year quarterly GDP growth rates. The IMF believes that Albania will be one of the few countries in Europe to have incurred positive GDP growth in 2009, of roughly 2 per cent, however much of this growth will have occurred in the first half of the year. Albania enacted some fiscal stimulus measures to stoke demand, through higher public-sector wages and significant spending on infrastructure projects. In Bosnia and Herzegovina, year on year quarterly changes in industrial production have 10 EIU, Montenegro Country Profile, February 2010 been consistently negative, contracting by 10.9, 9.9, and 12.6 per cent each quarter. Owing to its much closer economic ties to Russia, where GDP contracted by 9 per cent in 2009, Moldova displayed the poorest economic performance among the countries in this report.

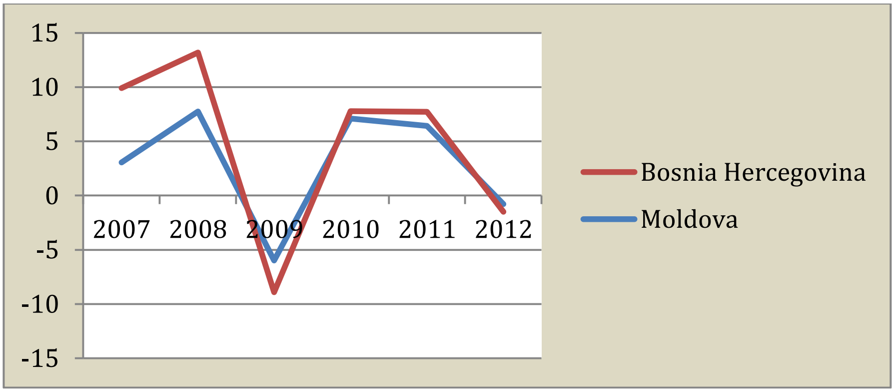

Figure 2: GDP growth rate trend Moldova and Bosnia Herzegovina

Source: World Bank 2013

The trade channel is an important area in which the crisis has been felt in the region, as depressed markets among the region's trading partners including Italy, Germany, and other Euro zone destinations for regional exporters, have negatively affected their performance and contributed to drops in industrial production. In Serbia, the EU accounts for more than half (55 per cent) of its export income, and year-on-year industrial production through 2009 was consistently negative, though the scale of decline lessened by the end of the year. Manufacturing output in the country estimated at 4.5 per cent of GDP and is also in part attributed to increases in spending, particularly in social transfers.

External financing, another element to the growth mix in recent years, has shrunk as investors display increasing risk-aversion towards emerging markets. The government of Serbia in its December 2008 memo on the effects of the crisis acknowledged the difficulty it expects in financing and covering its deficit in its balance of payments. The government duly sought and entered in to a Stand-By Arrangement with the IMF in January 2009 in order to address these concerns. Several privatization projects envisioned in the region, including in mining in Serbia and telecommunications in Bosnia and Herzegovina, have been delayed as result of the increased difficulty in finding investors in the current climate.

Remittance income from migrant communities abroad has also been affected by downturns in the sending countries. The Bank of Albania reports that remittances receipts for the third quarter of 2009 were down 6 per cent compared to third quarter 2008, falling from €620 million to €581 million.12 In Moldova, the decrease in remittance income contributed heavily to the GDP contraction of 9 per cent recorded for the year as it played an important factor in the country's decreased domestic consumption. The IMF estimates that consumption in Moldova contracted 7 per cent in 2009. Contraction experienced in the construction industry and declining service sector growth also played a role in the poor performance of the Moldovan economy. Though remittances contracted less globally than originally anticipated, the World Bank does not see remittance levels from 2008 being duplicated for years to come, and remittance growth to be essentially flat in 2010.

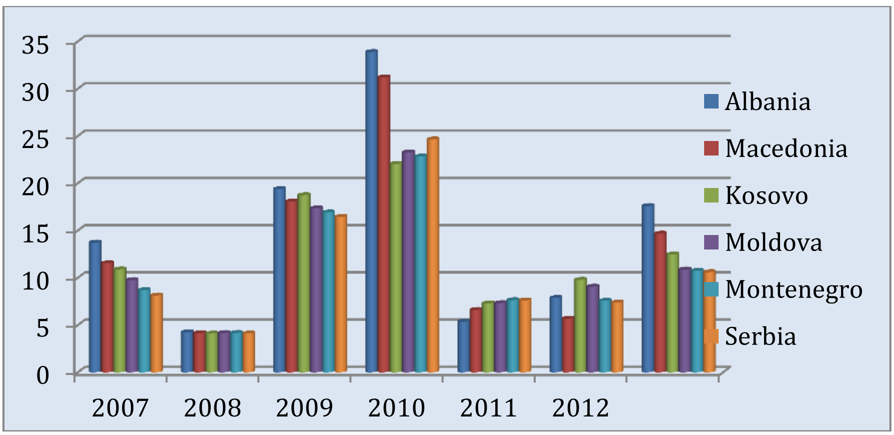

Figure 3: Remittances inflows trend in Western Balkans

Source: World Bank 2013

Moldovan exports for the year sank 18.4 per cent from 2008 to 2009, with metals and metal products suffering most significantly, falling by 75 per cent. Metals and textiles form the principle exports of the Macedonian economy, and suffered considerably for most of 2009, contributing to the decline in industrial production, as industry year-on-year third quarter performance in Macedonia slumped to -13.4 per cent. Despite favorable

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economic performance relative to its neighbors and in other European countries, Albania also experienced year on year second quarter industrial production contraction of 5.8 per cent, due to lessened demand for the products of its clothing and footwear manufacturers, and contraction in its mining sector. Industrial production and employment can be adversely affected by developments in a few important plants. In Montenegro for example, much of the downturn in manufacturing and industry is a reflection of troubles undergone by the Podgorica Aluminium Plant (KAP), the country's principle industrial firm. Industrial performance in Montenegro has been perilously hit by the crisis, registering a fall of over 56 per cent in September 2009, compared with a drop of 2 per cent for the entirety of 2008.10 Exports to Italy, the leading destination for Montenegrin exports in 2008, dropped precipitously in 2009 by nearly 70 per cent. In total, exports decreased by 38.1 per cent in year-on-year terms.

The decrease in economic activity is perilously affecting government fiscal balances, as tax revenues fall in accordance. For the Western Balkans, this is of even greater concern due to the outsized presence of the informal economy in regional economic activity and its tendency to grow during times of crisis, thus initiating a further strain on the tax base through the lack of tax receipts. Croatian central government revenue from January through November 2009 was down 5.9 per cent year on year. Budget deficits in 2009 have increased for most countries. Total revenue in Moldova in 2009 was down even further, at 8.9 per cent lower than in 2008. At the same time, government spending for the year was up by 4.6 per cent, most notably due to greater social assistance spending, which increased by 15.1 per cent. Albanian authorities have revised estimates of the year's deficit from 4.2 per cent of GDP to 6.9 per cent, in recognition of decreased economic activity and infrastructure spending, making the budget deficit in Albania by the end of 2009 at its highest point in eight years.

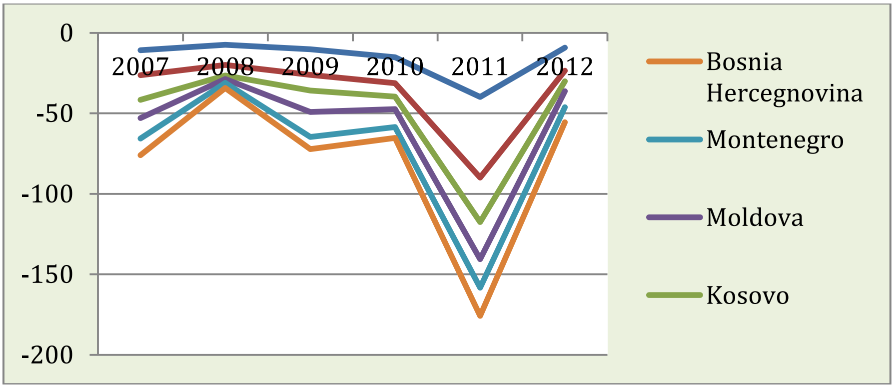

Figure 4: Current account balance trend

Source: World Bank 2013

Trade in the region has displayed sharper declines in imports as opposed to exports, on the account of strains upon remittance and credit-fuelled domestic consumption, thus current account balances and trade balances are showing signs of shrinking. Both remittances and foreign direct investment, in differing proportions throughout countries in the Western Balkans, have been crucial in financing the trade deficits, and consequently the current account deficits displayed in the region. In Bosnia and Herzegovina, the trade deficit for 2009 decreased by nearly 29 per cent compared with in 2008. The reduction of the Croatian trade deficit shrank in similar fashion, registering at 30 per cent less for the year in comparison with the previous one.

Effects of economic crisis on public debt

The best way to observe the effects of the economic crisis is monitoring the economic activities. There is a decline or slowdown in economic growth. The gross domestic product (GDP) is often used as an indicator of economic activities. The Western Balkan countries had solid GDP growth in the pre-crisis period. In 2007 it ranged between five and six percent, and in Montenegro even more than ten percent.

The adverse effects of crisis were already visible in the following (2008) year. All observed countries, except Albania, experienced the stagnation of economic activity and perceptible decline in the GDP. But, that was just the beginning of the crisis period, because in the next year the crisis manifested in the even more severe form. Economic growth rates were negative - in Croatia 6.95%, in Montenegro 5.70%, in Serbia 3.50% and in Macedonia it was the lowest amounting 0.92%. Since 2010 there was the period of slow recovery in economic activity.

The crisis consequences were mostly manifested in the largest economies, Croatia and Serbia. Albania is the only Balkan country that did not have a negative growth of GDP, although the economic stagnation is present there as well. It is not due to an increase in economic activity, but to the low starting position, or, in other words, the low level of economic development in previous period. A similar situation is when GDP per capita is used as an indicator of the development level. And there is also the decline of this indicator in 2009.

The Western Balkan countries have very low GDP per capita. In this regard, they are well behind other CEE transition countries in transition. Only Croatia, with a GDP per capita amounting over 10,000 euro, is far ahead of other countries from this region and it has even caught up with some present members of the European Union.

Foreign debt recorded permanent growth in the pre-crisis period due to large current account deficits and extensive private sector borrowings during the credit boom. In spite of the reduced current account deficits in 2009 and 2010, foreign debt recorded further growth in all countries of the region. This is mainly due to a substantial increase in public sector borrowing from the IMF or other IFIs, with the aim of stabilizing the financial sector, strengthening foreign reserves and financing capital investment.

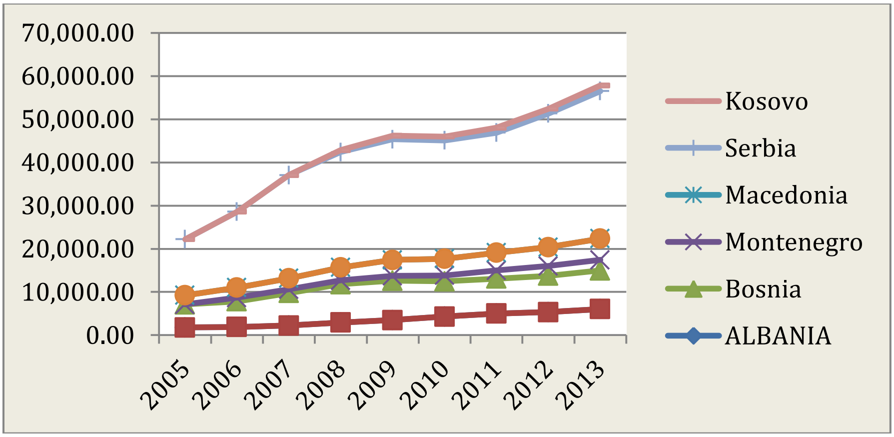

Figure 5: External debt, 2007-2013 ($)

Source: World Bank 2014

In addition, these countries also have a rather low competitiveness of their economies. Such situation is present during the long period.

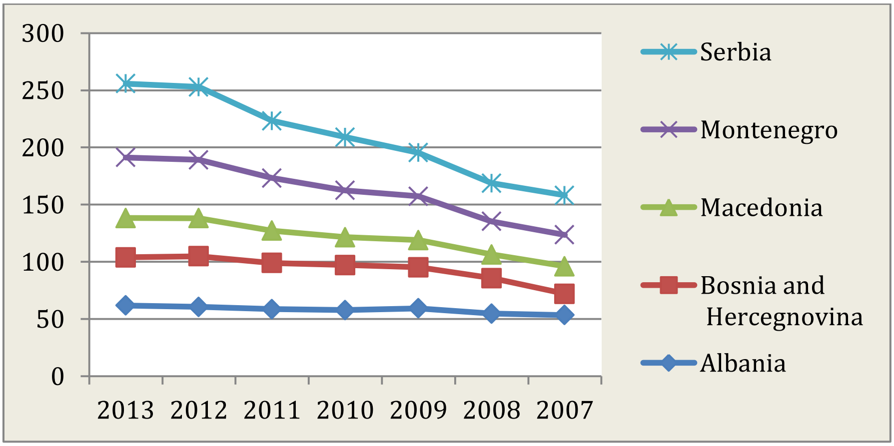

Figure 6: General government debt, 2007-2013 (% GDP)
Source: World Bank Database 2014

The general government debt increased from 37% of GDP in 2009 to 44% at the end of 2011 and debt levels remain high compared to pre-crisis levels of around 30% (Figure 1.4). This is mainly the result of the increased public sector borrowing from the IMF and other IFIs, with the aim of stabilizing the financial sector, strengthening foreign reserves and financing capital investment.

Indebtedness

Many of today's high-income countries went through debt defaults or rescheduling during their emerging market stage of development, some as long ago as the 13th century (Reinhart and Rogoff 2010). Contrary to widespread perceptions, the probabilities of a debt crisis seem to be determined by total public debt rather than by external debt alone. History also shows that the economic and social costs of these crises can be high in that countries in debt distress face higher financing costs and lower GDP and trade. A common estimate puts default "costs" at 2 percent of GDP growth (Sturzenegger 2002). De Paoli, Hoggarth and Saporta (2006) report much higher output losses—on the order of 7 percent per year for their median country. Tomz (2007) finds that output is 1.4 percent below trend during periods of default compared to 0.2 percent above trend when the borrower is in good standing. There exists empirical evidence that the higher a country's debt level, the lower the quality of its policies and institutions; and the higher the probability of shocks, the more likely it will fall into debt distress (Kray and Nehru, 2004). While the risk of debt distress clearly tends to rise with debt, what exact level is acceptable and compatible with fiscal sustainability is to some extent a matter of judgment. Still, empirical analysis of emerging markets has shown that countries can enter debt crisis even when debt is surprisingly low: in 55 percent of debt defaults of middle income countries, public debt was below the Maastricht benchmark of 60 percent of GDP, and in 35 percent it was less than 40 percent (IMF 2013).

Indebtedness is a global problem today. The state, companies, individuals are in debt. It is estimated that the total global debt amounts more than 55,000 billion dollars, which is about 140% of the world gross domestic product. Moreover, it is increasing at a rate of 6 to 8% per year, four times faster than the growth of gross national product (10). Many countries are in the category of highly indebted, and some of them are even on the brink of bankruptcy. In addition to the low level of development, Western Balkan countries are faced with high indebtedness. The total amount of external debt in Croatia (94.9%) and in Montenegro (94.6%) in 2011 approached the achieved level of GDP. In somewhat more favorable position is Serbia (84.9%), but it also passed the limit of high indebtedness. Mentioned countries are followed by Macedonia (65.0%), Bosnia and Herzegovina (46.5%) and finally, Albania (51.7%).

In addition to the total debt, the Balkan countries have quite high public debt as well. This is particularly evident since 2008, with the emergence of the global economic crisis.

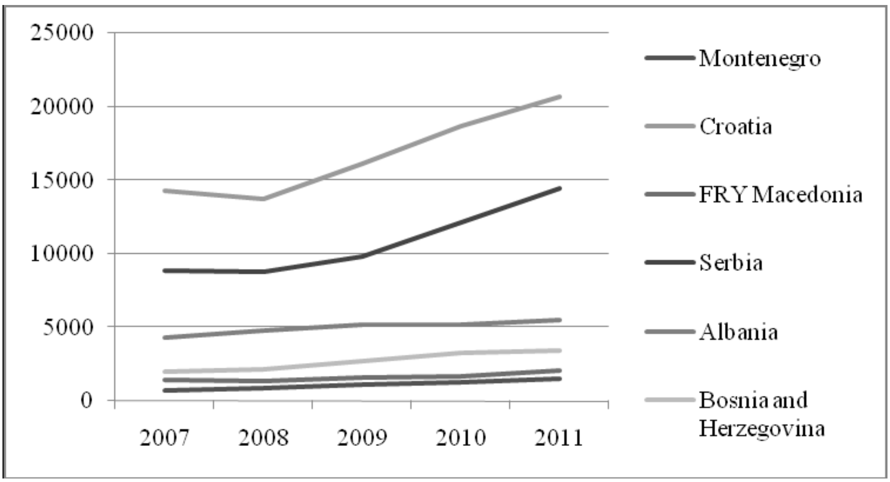

Figure 7: Public debt in Western Balkan countries

Source: IMF 2013

The leading economies have the highest debt. At the end of 2011, public debt of Croatia is 20,712 million euro, and it is higher than five years ago for 45%. Serbia also increased its indebtedness by even 63% in this period, and now (2011) it amounts to 14,467 million euro. Albania also has a high debt, amounting 5,534 million euro.

The best insight in Balkan countries high indebtedness is provided by data on the share of their public debt in GDP. The situation has been worsening from year to year. Public debt in Albania has been approaching 60% of GDP, and the countries with high public debt are also Serbia with

46.45%, Croatia 46.11% and Montenegro 45.20% of GDP. Two other Balkan countries have lower debt - Bosnia and Herzegovina 26.09% and Macedonia 28.60%. The dark picture of indebtedness of the Western Balkan countries is completed by taking into account the public debt/export ratio.

Albania’s general government debt, including state guarantees, stood at ALL 872.2bn (EUR 6.23bn) at end-September 2013, unchanged from the previous quarter, data from the finance ministry showed. Domestic government debt edged up by 0.1% on the quarter raising its share in the total to 57.4%. External government debt was flat q/q and accounted for 42.6% of the total.

The state guarantees totaled ALL 53bn, comprising 6.1% of the overall general government debt.

The gross central government debt (i.e. central government debt excluding guarantees) edged down by 0.1% y/y to ALL 818.8bn as of end-September. In terms of debt composition, the share of government securities was 59.9% at end-September, marginally down from year earlier.

The IMF, the World Bank and the EBRD have repeatedly warned that the Albanian economy faces increasing challenges from its high public debt that is exceeding its statutory limit of 60% of GDP. The international institutions believe that the relatively high level of indebtedness is putting pressure on the country’s economic growth prospects, while limiting the room for fiscal maneuvers. According to the updated economic and fiscal program of the Albanian government, the public debt is expected to increase by 1.9 pps this year and equal to 63.8% of the GDP.

Albania's central bank has recently called for the introduction of new fiscal measures in order to ensure long-term sustainability of the public debt. The bank believes this will boost confidence in the financial markets and will support reduction of the long-term costs of debt service.

Conclusions

Global crisis has worsened already complex economic reality of the Balkan countries. The crisis recession has emerged. The consequences are the most pronounced in the leading economies, Croatia and Serbia. As elsewhere in Central and Eastern Europe, transition countries in the European super periphery have been adversely affected by external events originating in the USA and the core EU member states. While the global economic crisis has had a severe negative impact on Western Balkans countries, its magnitude has varied across countries. Some countries were very badly affected in 2009 with sharp declines in GDP, industrial production, and exports, while other countries have been relatively less affected. In some countries the contraction persisted in 2010, while in others only a shallow recovery was evident. Only Albania is an exception to this general picture. Crisis, the economies of these countries have experienced a new decline. The former solid economic growth has been stopped, business environment exacerbated, the economy competitiveness reduced. Under such circumstances, but also due to the global crisis, foreign direct investment inflow was very low, which, with modest domestic accumulation, did not provide any radical changes in the field of new employment. In addition, the standard of living is alarmingly low, with a tendency of constantly poverty increasing.

Today, the Western Balkan countries tend to achieving two basic goals – achieving sustained political stability and finding exit from crisis with the sustainable economic growth. At the same time, all the Balkan countries are implementing the intensive transitional reform processes. They are aimed to build a new model of economic growth that should enable exit from the current crisis. The orientation is on the higher production of tradable goods, primarily by re-industrialization, increasing export and reduction of the high public spending. This would lead, along with the employment increase, to significant reduction of the present imbalances, indebtedness, and improvement of general welfare of the people.

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