

SURVIVING THE CREDIT CRUNCH

The performance of the economy in Croatia, Bosnia and Serbia has mirrored that of Europe and after an initial dynamic recovery, growth in the Western Balkans is now slowing. However, going forward it is expected that growth will continue and be higher than in advanced economies.

Higher relative growth is expected because the economies are not directly affected by the sovereign debt crisis. This reflects the fact these governments have issued fewer bonds (in Bosnia's case none) providing a sounder fiscal standing and therefore lower budget deficits. As a result, the average deficit in 2009 was 4.4% which compares favourably to many Western economies who recorded deficits of over 10%.

However, going forward there are problems which will have the potential to reduce growth in each country. In particular liquidity levels will have to be maintained. The main lending banks in the region are from Western Europe and these banks have invested heavily into sovereign debt and therefore their liquidity levels have an indirect impact on the region's economy.

Equally these banks have also lent heavily to banks from other countries such as Ireland (German banks have exposure to Irish banks equating to 4.2% of GDP) which means that the region is indirectly affected by the performance of western economies. However for the last two year the banks have willingly adhered to the 'Vienna Initiative' which was implemented in 2009 to ensure historic liquidity levels were maintained by international banks. The initiative was successful but expired at the end of 2010. However all banks are expected to continue to uphold liquidity to the region going forward.

Moreover the banks are making encouraging steps to make the region less dependent on foreign capital. Much of the debt was based on Euro and Swiss Franc denominated loans which offered lower interest rates than domestic loans. As a result EBRD are pioneering the 'Vienna Plus' initiative which aims to orientate lending in these countries towards domestic currency. To do this local currency bond markets are being developed to facilitate long term funding. Going forward it is expected that this will reduce currency and liquidity risk, which will in turn encourage Foreign Direct Investment.

CROATIA

- 2009** Economic Crisis resulted in GDP growth of - 5.8%
- 2010** Although GDP grew in Q3, GDP will be negative (-1.5%) for 2010. Tourist industry is benefited from economic and civil strife in Greece resulting in strong results.
- 2011** Completion of EU accession talks is expected to increase FDI. EBRD expects GDP growth of 2%

Each country has also benefited from significant economic reform on a public level. Both Serbia and Bosnia have borrowed from the IMF and in return have implemented unpopular but essential spending cuts that might have otherwise been impossible to realize. For instance Bosnia has committed to reducing their budget deficit to 3% of GDP in 2011, while Serbia has committed to a budget deficit of 1% and public debt limit of 45% of GDP. Croatia has resisted assistance from the IMF and has been slower to implement reforms but will have no choice but to make unpopular decisions on sensitive issues such as privatisation with EU accession pending shortly.

From a macro economic perspective the economic performance in the Western Balkans is more closely linked to performance of Austria and Germany, its closest neighbours in the Euro –Zone and their main export partners. These economies are currently recording strong growth and are expected to carry economies in the Western Balkans in the medium term. As a result industrial production in Croatia, Bosnia and Serbia has increased over the last 12 months and is expected to continue to grow over the next 2 years.

Although the overall picture is positive there are challenges facing each country. Within Bosnia the currency peg to the Euro has reduced complete advantage of the country with regard to exports, but on the flip side the low cost of labour has encouraged growth in new manufacturing plant. Likewise Croatia, a member of the European Monetary Union, has also struggled with the strength of their currency relative to the Euro, but this has been offset by stronger than expected performance in the tourist sector which contributes 25% of GDP. While Croatia and Bosnia have suffered from relative strength in their currency Serbia does not have a currency peg so the slide in the Dinar has encouraged exports, which has now led to an increase in domestic demand. However going forward there are concerns that this might lead to an increase in inflation and foreign debt obligations which will have to be monitored.

The future therefore has challenges but is shouldn't be forgotten that only 15 years ago these countries were enduring a civil war, so the region has not moved from socialism to capitalism as quickly as other transitional economies. This has created problems in the past as the region has struggled to keep pace with countries such as Hungary, Romania and Bulgaria. However with hindsight this has proved to be a positive as the company still benefits from low levels of debt, cheap labour costs and increasing foreign investment which going forward provide a encouraging platform for economic growth.

SERBIA

- 2009** Economic Crisis resulted in GDP growth of - 3%
- 2010** GDP will be 1.5% for the year as a result of growth in transport, communication, industrial production and financial intermediation sectors
- 2011** GDP forecast to continue with boost from finalisation of privatisation programme

BOSNIA

- 2009** Economic Crisis resulted in GDP growth of – 2.9%
- 2010** GDP will be 0.5% for the year as a result of growth in industrial production
- 2011** GDP forecast to continue as a result of further growth in industrial production. Growth may be hindered by fractious political environment after 2011 elections did not result in clear majority