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The Impact of the Current Economic and Financial Crisis on the Black Sea Region

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Abstract

The Black Sea Region was impacted severely by the advent of the September 2008 global financial and economic crisis. Access to financing disappeared, especially hitting economies that are dependent upon external financing flows. Timely government interventions averted financial collapse, but a sharp economic downturn followed, which for most countries has resulted since then in economic contraction and uncertainty concerning future performance. Black Sea countries are currently coping with the downturn, mostly individually, but recovery also depends on exogenous factors and developments, namely the situation internationally in general and within the eurozone in particular. Aside from increased official lending, there has been no direct support or cooperation at the regional and international level, nor has there been any support from the European Union's side. A full return to previous high growth appears unlikely, but medium-term prospects are good for resumed growth, even at lower levels.

Keywords

Black Sea region, bottoming out, consultation mechanism, credit rating, financial crisis, International financial institutions (IFI), liquidity support, multilateral swap arrangements, Organization of the Black Sea Economic Cooperation (BSEC), swap lines.

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From crisis to crisis

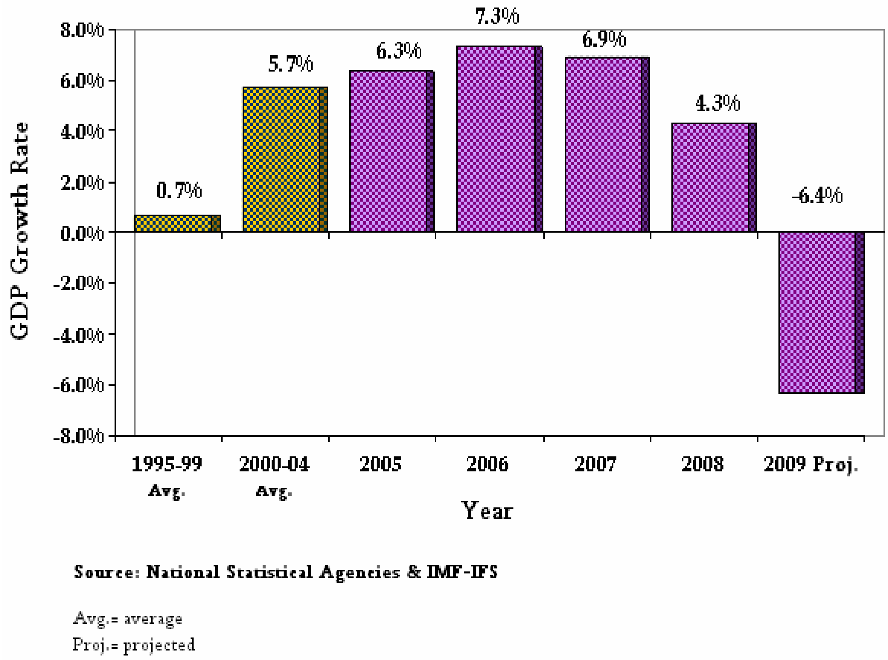
The Black Sea Region[1] has been no stranger to economic crises over the past two decades. With the exception of Greece and Turkey, all the other countries are former "transition states" which at various points from 1989 to 1991 initiated massive efforts to shift from centrally planned economic systems to market based systems. Throughout much of the 1990s, this economic transition, coupled with political developments such as the dissolution of the Soviet Union and Yugoslavia and the creation of many new independent states, resulted in political crises that were accompanied

Note on Sources: unless otherwise specified, Black Sea Region data is based on calculations from National Statistical Agencies of the Organization of the Black Sea Economic Cooperation (BSEC) countries and the International Financial Statistics (IFS) database of the International Monetary Fund (IMF). Additional sources include Global Economic Prospects 2009 (and 2008) of the World Bank, and the IMF's World Economic Outlook publications.

[1] For purposes of this Policy Brief, the term "Black Sea Region" is used for the twelve member states of the BSEC – Albania, Armenia, Azerbaijan, Bulgaria, Georgia, Greece, Moldova, Romania, Russia, Serbia, Turkey and Ukraine. All are considered part of "Eastern Europe" except Greece, which is a eurozone member. The term "Eastern Europe" covers all the states of Central and Eastern Europe which are in the process of converging (some already have) with the key economic indicators of the fifteen European Union (EU) members before the EU enlargement of 2004. It covers new (post 2004) EU member states, candidates and potential candidates, as well as Eastern European states that do not enjoy EU membership perspectives. It is preferred over the term "Emerging Europe", even though they largely cover the same set of countries.

by a significant economic contraction, declining living standards, and macroeconomic instability.[2]

Table 1: Black Sea Region Growth 1995-2009



A second major economic crisis resulted in the aftermath of the financial crisis which began in Russia in August 1998 and swiftly spread to many neighbouring states.[3] However, recovery from this second crisis was swift, due to benign global conditions and the successful policy reforms undertaken by the afflicted countries. A lengthy period of robust growth ensued between 2000 and 2008, with annual gross domestic product (GDP) growth in the Black Sea Region averaging 5.9%, and every country experiencing uninterrupted positive growth from 2002 on (see table 1). Economies expanded, incomes and living standards rose, and significant structural progress was achieved, improving the business environment and

[2] Stanley Fischer and Ratna Sahay, "The Transition Taking Stock", *Finance & Development Magazine* 37, no. 3 (September 2000), http:// www.imf.org/external/ pubs/ft/fandd/2000/09/fischer.htm.

[3] The 1998 Russian financial crisis has been analysed and reviewed extensively. One useful review is Brian Pinto, Evsey Gurvich, and Sergei Ulatov, "Lessons from the Russian Crisis of 1998 and Recovery" (Washington, D.C.: The World Bank, February 2004), http://www1.worldbank.org/economicpolicy/documents/mv/pgch apter10.pdf.

building upon solid macroeconomic fundamentals. As a result, various country risk measures improved, including sovereign credit ratings, and financing from abroad flowed in. In particular, foreign direct investment (FDI) boomed, rising sixteen-fold from US$8 billion (1.1% of Regional GDP) in 2000 to US$130 billion (3.9% of Regional GDP) in 2008.

The current, third major crisis to strike the region over the last twenty years, is different from its predecessors both in terms of scope and nature. The previous ones were closely linked to the region, although the 1998 financial crisis arguably had roots in the Asian financial crisis of 1997. By way of contrast, the current crisis is global in nature, and has resulted from events taking place in the most developed, wealthiest markets – particularly the United States. It has consequently created a host of new challenges for the Black Sea Region, and its scope and severity threatens to reverse years of economic progress in certain countries.

Although the high Regional growth of recent years had been triggered by rapidly increasing foreign investment levels and productivity gains, it had also frequently been accompanied by pro-cyclical policies and rising wages and asset prices, sharply increased private sector borrowing levels, and growing domestic demand which created conditions of overheating and accumulation of internal and external imbalances in a number of economies. This confluence of factors, a cause for concern and remedial policy reform, but not a dire threat to continued stability and growth, suddenly became prohibitive failings that brought a cascade of economic crises across the Black Sea Region as a result of the panic-like risk aversion that gripped financial markets in the fall of 2008. In addition, the economic contraction in Western Europe reduced foreign demand for regionally produced goods, while declines in commodity prices negatively affected resource rich countries.

Any underlying trends of "decoupling" between the developed markets of the West and the rest of the world were overwhelmed, at least temporarily, thus resulting into a highly globalised contagion. Furthermore, the global financial crisis underscored a strict re-affirmation of the hierarchy of access to financing based upon perceptions of country risk, which are determined in turn by a combination of sovereign credit ratings, levels of development, and overall economic size and performance. This has resulted in a "financial food chain", in which the highest rated enjoy first preference, at reduced prices, while the lower rated scramble over the remainder available funds and must pay more. Thus, while restoration of credit flow to the region represents a critical element to recovery from the crisis, Black Sea countries, none of which enjoys an AAA or AA credit rating, face the threat of being crowded out of markets by the record borrowing planned by higher rated countries as they try to stem economic decline and stimulate their own economies. At a minimum, the increased competition for available funds has resulted in higher interest rates for Black Sea countries, and the lower a rating that a country carries, the higher the costs that it will face.

Currently, with markets remaining dysfunctional, official sources of financing represent the primary option for most Black Sea countries (except Greece) to access external financing. In contrast to the United States or Western Europe, Black Sea countries are unable to take measures sufficient to re-open lending. Most of the economies are too small for capital injections to achieve the required degree of stimulus.[4] Moreover, their currencies lack reserve currency status and as such they are unable to inject sufficient liquidity into their financial systems without drawing down reserve levels and risking severe capital flight or even collapse. Available official sources include international financial institutions (IFIs) and donors, particularly the EU. IFIs have increased significantly their commitments to record levels. The International Monetary Fund (IMF) secured the agreement of its members to quadruple its available resources early in 2009, and it has concluded agreements worth tens of billions of dollars with a number of Black Sea countries.[5] The World Bank, the European Investment Bank, and others have accelerated their lending as well. Nevertheless, even at this record pace, official flows will fall well short of the levels of private financing provided in previous years. It is expected that official flows in 2009 cumulatively will reach barely 10-15% of the peak levels of private financing provided in 2007.[6]

The situation is worse for banks and firms in the Black Sea Region, as they effectively cannot access financing from most international lenders – upon whom many had relied prior to the crisis. For small and medium

[4] Only Russia, by far the largest economy in the region, attempted an explicit fiscal stimulus programme. While it may have stemmed some economic decline, there is no consensus as to whether it was successful or not. What is clear is that it contributed to an extensive drawdown of the country's foreign reserves

[5] At the time of writing, Albania and Moldova have concessional programmes with the IMF under implementation, while Armenia, Georgia, Romania, and Ukraine have non-concessional Stand-By Arrangements (SBAs) under implementation. Turkey is in negotiations with the IMF on a possible SBA.

[6] See: Institute of International Finance, "Capital Flows to Emerging Market Economies", Report (Washington, D.C.: IIF, 11 June 2009); International Monetary Fund, *World Economic Outlook: Crisis and Recovery* (Washington, D.C.: IMF, April 2009); International Monetary Fund, *World Economic Outlook Update*, 8 July 2009.

enterprises (SMEs) the situation is especially difficult, and their heavy reliance on SME schemes by donors and development banks for financing closely mirrors that of the early years of the transition process from centrally planned to market oriented economies. Despite mass injections of funds from central banks and governments, the capital position of many banks risks further deterioration as losses are realised.

The impact has thus been negative on the Black Sea Region, although the extent of damage has varied from country to country. All expectations are that the Black Sea Region will suffer a contraction in 2009 with negative real rates of GDP growth on the order of -6%. There are also concerns that the economic crisis has not yet "bottomed out" and that further decline in economic performance in countries individually – and the region collectively – is possible before elements of a recovery take hold. Prospects for 2010 are thus uncertain.[7]

Financial system impact

The financial systems of the Black Sea Region display substantial heterogeneity in terms of size and structure. They range from the largest, most advanced and deepest in the case of Greece with domestic credit at around 110% of GDP, to the smallest and simplest in the case of Armenia, with domestic credit at around 5% of GDP. Generally, EU member states (Bulgaria, Greece, and Romania) and candidate countries (Turkey) tend to have larger and more sophisticated financial systems than countries without EU membership perspectives. Significantly, the "EU tied" financial systems tend to be more inter-linked, with greater degrees of cross-border lending and ownership than in the case of other financial systems. In most countries, there are a few dozen banks active, and assets and activity tend to be highly concentrated in four to five major banks. A key exception to this is Russia, which still has more than 1,000 banks in operation, many of which act as treasuries of affiliated companies, though this number has been declining in recent years and the state-owned Sberbank still is, far and away, the largest bank in the financial system. Substantial degrees of foreign ownership are common in most countries, with the vast majority of the banking system in Albania, Bulgaria and Romania owned by foreigners. By way of contrast, Greece and Russia have the smallest degree of foreign bank ownership.

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[7] See IMF, *World Economic Outlook: Crisis and Recovery*, among the many like minded publications as far as the projection for 2010 is concerned.

Despite the considerable variation, the onset of the crisis created similar effects from country to country. The financial systems remain under stress. Lending to private companies is limited and there has been a painful process of deleveraging that in turn has resulted in a downturn in economic activity. However, the systems have not collapsed, and they have avoided the bank failures that marred previous crises and in turn fed a feeling of panic in places like Russia in 1998 or Turkey in 2001. Despite fears about expected increases in losses in the future as the effects of recession hit companies and consumers, unless the economic downturns result in sharp increases in non-performing loans, most banks in the Black Sea Region seem to be adequately positioned to weather the difficulties. If not on their own, then with the backing – explicit or discreet – of the national governments. Significantly, in many countries much of the banking system was foreign-owned (mainly western European) and there were fears that parent banks might withdraw support from their local branches or subsidiaries. To date, that has not happened and with the limited return of investor risk appetite in the second quarter of 2009, parent banks have continued to support their local holdings or pledged to do so, maintaining their exposure and in certain instances injecting additional capital. Western European banks have rolled over and renewed most of their maturing loans to Eastern Europe. The massive liquidity injections of the European Central Bank (ECB) have certainly played a role, as eurozone banks have accessed the facilities of the ECB and then used a portion of the proceeds to maintain activities in Eastern Europe. Thus, while the ECB has not directly lent outside the eurozone to banks, and has had limited dealings with Eastern European central banks (credit lines), there is strong evidence that it has played a key role, albeit indirectly, in improving liquidity conditions in Eastern Europe.[8]

The financial crisis in Black Sea countries

The individual responses of countries have varied, depending upon their specific circumstances, their particular macroeconomic situations, the health or vulnerability of their financial sector, and the severity of the impact of the financial and economic crisis. Some have introduced major recovery programmes, while others have intervened minimally. Those with large reserves have applied them to support their currency and stimulate the economy (or at least mitigate the downturn), while others

[8] The degree to which this has occurred is impossible to determine, due to the fungibility of money, but indications are that it has been substantial, and possibly greater than the amounts committed by IFIs and donors.

have either applied to the IMF and other multilateral lenders for assistance, or are in discussions to do so.

Bulgaria's monetary policy has been constrained by the currency board arrangement which ties the lev to the euro. For example, the Bulgarian National Bank (BNB) cannot set interest rates, nor can the lev be devalued relative to the euro without risking the collapse of the entire arrangement. Instead, BNB has limited policy choices such as expanding deposit insurance to improve confidence, and reducing minimum reserve requirements for banks in order to boost domestic lending. Despite moderately high lending growth in recent years, the banking system has benefited from prudent regulation which ensured that banks were adequately capitalised. Most of the banking system is foreign-owned, and despite fears that the parent banks might withdraw from Bulgarian based branches or subsidiaries, they have thus far maintained their commitments to their investments. Although the economy is contracting, deleveraging in the financial system has been low compared to other Black Sea countries, and Bulgaria has thus far not shown interest in requesting assistance from the IMF.

Greece, the country with the largest financial sector in the Black Sea Region, introduced a €28 billion scheme to support the banking industry which included €5 billion in equity injections, €15 billion in state loan guarantees, and €8 billion in special bonds to support banks. Even though no Greek banks collapsed or explicitly needed the assistance in the aftermath of the 2008 crisis, the government pre-emptively inaugurated the scheme in order to demonstrate its commitment to maintaining the health of the financial sector. Controversially, the Bank of Greece (BoG), which regulates financial institutions, tried to discourage Greek banks from using portions of the scheme to support their extensive subsidiaries and other holdings in other Black Sea Region countries such as Albania, Bulgaria, Romania, and Serbia, though the Greek banks seem either to have ignored the BoG or to have applied funds from the ECB. Greek banks have accessed ECB facilities extensively and have applied sizeable portions to purchasing Greek government debt.

Nearly 90% of Romania's banking sector is foreign-owned, and at the start of the crisis most banks were well capitalised. However, domestic credit growth had increased at an annual rate of over 40% between 2001 and 2008, spurred in latter years particularly by external borrowing by banks which left the financial system vulnerable. As liquidity froze, the government and national bank responded by increasing deposit insurance, reducing reserve requirements and stepping up monitoring, while also liaising with the parents of foreign owned banks and even the home country governments of these banks to ensure that they would maintain their exposure to Romania and recapitalise subsidiaries as needed. To date, the parent banks have done so. In May 2009, Romania reached agreement with the IMF on a €12.9 billion SBA as the centrepiece of a €19.9 billion multilateral assistance programme which also includes the EU. One objective of this SBA is to maintain the adequate capitalisation of banks and liquidity in financial markets.

Russia adopted a broad range of fiscal and monetary policy measures. With the rouble coming under severe depreciation pressure in the second half of 2008 and capital flight accelerating, the Central Bank of Russia spent more than US$200 billion, nearly one third of accumulated reserves, to support the exchange rate and manage a slower rate of depreciation. In view of the explosion of foreign currency lending by private firms and banks in Russia in previous years, the support to the exchange rate was costly, but it may have averted a financial collapse brought about by currency mismatches. The government followed with an extensive fiscal stimulus programme to stem a decline in economic activity and a 500 billion roubles support programme for the financial sector which on the one hand explicitly covers the 50 largest banks and leaves open the possibility of selectively supporting others, but on the other hand seeks to stimulate consolidation in the financial sector and reduce the overall number of banks, by forcing small and moribund banks to close or be sold.

Serbia is similar to other Balkan countries in the sense that its banking system is foreign owned and thus was well capitalised at the onset of the crisis. Faced with a sharp economic downturn and limited access to finance, Serbia applied to the IMF for assistance and in April 2009 reached agreement on a €3 billion SBA. While the SBA contains painful fiscal adjustments, it also supports the establishment of a financial sector support programme via a combination of commitments (by participating banks) and incentives from the government to ensure that

- the banking system's capital and liquidity levels remain adequate;
- external financing remains available and in line with SBA programme assumptions; and
- participation on the part of banks is attractive as the participants gain access to a dinar liquidity facility and a foreign currency swap facility.

Foreign banks, in particular, have been asked to maintain their exposure to Serbia and to keep subsidiaries well capitalised, something which has occurred thus far, as in neighbouring countries. The government has also enhanced deposit insurance and agreed to conduct stress tests to ascertain the health of major banks.

Banks in Turkey have weathered the current crisis relatively comfortably. In the aftermath of the 2001 crisis in Turkey, the financial sector was reformed, strengthened and regulated more conservatively. Despite high economic growth rates, the size of the financial sector was relatively modest, with the level of domestic credit less than 50% of GDP, and annual growth from 2003 to 2008 less than 20%.[9] As a result, Turkish banks were less exposed as financial markets froze, and have encountered less strain. Despite a contraction in economic activity, the government has not felt the need to institute any programme of bank support, its sole initiative being a contribution to a guarantee fund for SMEs, which is mainly targeted at stimulating economic activity and fighting unemployment, not at supporting the financial sector. Turkey has been in negotiations with the IMF on a SBA Agreement for months, but no agreement has been reached to date.

Ukraine was arguably the worst hit Black Sea country by the financial and economic crisis. In the run-up to the crisis, there was concern that the Ukrainian economy was overheating, with rapid lending growth – much of it borrowing in foreign currencies by private firms and consumers –, a rising current account deficit, declining export receipts, and a weak government. Domestic credit grew at an annual rate of 70-80% for the three year period 2006-08, reaching more than 80% of GDP. The onset of crisis reversed years of economic growth, as the perceived vulnerabilities resulted in a halt to foreign financing. In November 2008, Ukraine was the first country in the aftermath of the crisis to agree to a US$16.4 billion SBA with the IMF. Part of the agreement involved a programme to support the financial sector by recapitalising the largest banks with state funds, with the additional requirement for sectoral reforms such as arranging for the resolution of insolvent banks, and introducing legislation to improve disclosure of ownership. In addition, the National Bank of Ukraine has provided liquidity support to Ukrainian banks. While a collapse has been averted, the economy is going through a painful contraction made worse by sharp deleveraging, as domestic credit is expected to drop to near 50% of GDP by the end of 2009.

In Albania, Armenia, Azerbaijan, Georgia, and Moldova, the relative insularity of the economies protected them from the worst fallout of the financial crisis, and while banks have come under strain, there were no failures of note, nor any imminent threat of collapse. Government

[9] Except for 2006, when it temporarily "spiked" to 25.6%.

responses have included SME support schemes which indirectly help banks via guarantees and provision of targeted financing, and increasing of ceiling limits on deposit insurance, while measures by central banks have included injections of liquidity, and a general easing of monetary policy via cuts in interest rates. Azerbaijan, supported by ample reserves from energy exports, has sought to stimulate the economy by increased government spending and introducing subsidised lending schemes rates in order to spur private lending and investment. Albania and Moldova have concessional programmes with the IMF under implementation. Armenia and Georgia, by way of contrast, have "graduated" to non-concessional SBAs currently under implementation. These SBAs are much larger in size, US$822 million and US$1,170 million respectively, and an indication of the increased maturity and confidence of the economies under implementation. In contrast to the rest of the region, Azerbaijan will experience positive real growth of 2-3%, and Albania expects marginally positive growth. Armenia, Georgia, and Moldova expect negative growth in 2009, but a return to positive growth in 2010.

Going back two years, before the crisis hit the Black Sea Region and while growth was still robust, the stock exchanges of Black Sea countries have had a fairly correlated performance.[10] Their indices peaked in late 2007, and during the first eight months of 2008 experienced a steady, gradual decline before dropping sharply over the last four months of the year as the crisis worsened. The downturn continued into the first quarter of 2009 with most markets bottoming out in March, by which time they had lost at least 70% of their value relative to late 2007, and in some cases more than 80%. Starting in March, a modest recovery began globally which extended into the Black Sea Region and which has continued through the second and third quarters of 2009. Exchanges have risen at least 40% during this period, and in some cases over 60%. Even so, at the time of writing, the Black Sea Region stock exchanges are still off approximately 60% relative to the late 2007 peaks, and have suffered a bigger downturn than the stock exchanges in other former transition countries in Central and Eastern Europe which are down approximately 30-50%.

Restoring financial systems – policy response

The question of restoring financial systems to health after a crisis has to focus on two elements – one is the financial system overall, while the

[10] Data from www.mscibarra.com, www.bloomberg.com, and selected Black Sea Region stock exchange websites.

other is the measures undertaken for banks individually to make sure that those which are viable and function properly, are regulated appropriately and are adequately capitalised. Those that are not viable need to be removed from the market and placed either in bankruptcy or special resolution regimes that deal with their assets and liabilities transparently (and consistently) and either close them, sell them, or restructure them without extensive legal, financial, and other transactions costs.

At this point, a distinction is required as to the impact of the financial crisis. At the systemic level, Black Sea financial markets froze at the onset of the global crisis, and while government intervention averted collapse, the systems remain dysfunctional and access to credit is more difficult and more expensive than prior to the crisis. In short, these markets have slowed down and a process of deleveraging is ongoing which may last for a long time, constraining growth in the real economy.

At individual bank level – namely, the components of the financial sector – the impact of the crisis has been more limited (due mainly to a prudent recent record of regulation and timely government interventions). Individual banks in the Black Sea Region remain well capitalised, and have successfully avoided the worst effects of the liquidity crisis, nor have they suffered from significant impairment of their loan portfolios. However, if the economic downturn persists and at least a stabilisation of economic activity is not achieved, defaults on loans to companies and household may increase. Such a scenario can be avoided, but in all likelihood it is better for the authorities to be proactive and prepare for the worst.

At individual country level, a set of actions to mitigate systemic risk should be considered, including:

- inducing banks to restructure proactively loans that have good prospects for repayment, but for which obligors are temporarily facing problems due to the crisis;
- inducing banks to seek recovery of exposures where obligors appear likely to fail and where chances of restoration of financial viability is unlikely;
- providing liquidity support prudently – amply but not at terms which effectively subsidise banks (or other firms);
- requiring banks to raise capital in markets (or accept government interventions) as well as imposing stricter requirements on capital and liquidity levels;

- considering establishment of specialised institutions which would purchase part of the non-performing loans;[11] and
- further exploring ways to strengthen regulation and supervisory capabilities in order to minimise the risk of a systemic crisis.

At the regional level, the establishment of a consultation mechanism among the supervisory authorities of Black Sea countries might be useful, particularly for banks with cross-country operations. In addition, the coordination of response to cases of banking failures would be welcome in order to avoid a contagion that may lead to a domino effect.

At a systemic level, in addition to policies that address or help manage systemic risks so as to maintain solvency, there is the question of ensuring the flow of liquidity within the financial sector and to the economy as a whole. Restoration of credit flow to the Black Sea Region represents a critical – although not sufficient – element to recovery from the crisis. Since most Black Sea countries lack a currency with reserve status and access to foreign currency remains expensive, they have to select from among other options, such as:

- undertaking policy measures by themselves (individual country options);
- seeking support from external sources or externally initiated programmes (externally supported options); and
- seeking – a less likely option – to forge regional agreements (regional options).

While many of these options are helpful and highly desirable policy measures, they lack the directness and immediacy of impact of the fiscal and monetary stimulus measures undertaken by the United States and Western Europe in order to kick-start stalled financial systems and limit the ensuing economic downturn.

Individual country options

Despite increased reserves and the high growth of previous years, the lack of reserve currency status and perceived external vulnerability limit the scope for options such as aggressive fiscal stimulus and the easing of monetary policy undertaken by more developed economies. To the extent

[11] This is sometimes known as the creation of "bad banks". Much literature is available on the topic, but one summary of the way it would work is available at: http://woodwardhall.wordpress.com/2009/02/23/the-right-way-to-create-a-good-bank-and-a-bad-bank/.

these are lacking, for most Black Sea countries the likeliest responses involve austerity to constrain demand, shore up revenues, reduce debt servicing requirements and regain or increase the confidence of markets. Countries have it well within their power to ensure domestic laws and frameworks exist

- to improve the business environment, including the ease of creation and operation of firms;
- to upgrade the quality and transparency of public and private governance;
- to facilitate rapid debt restructuring and corporate reorganisation – including bankruptcy;
- to establish targeted social safety nets, within the fiscal means available, to assist unemployed workers and disadvantaged groups to mitigate some of the worst effects of the crisis; and
- to institute mechanisms to help restore the functionality of the domestic financial systems – including measures such as ensuring the health of banks and ensuring capital adequacy, improving regulation and enforcing rules fairly and objectively, establishing or improving credit and collateral registries, etc.[12]

Externally supported options

This covers official bilateral and international financial assistance as well as externally initiated forms of institutional coverage.

For many sovereign borrowers in the Black Sea, official lending is the only realistic option for accessing external financing, and in the first half of 2009 only Greece, a eurozone member state, issued bonds for substantial sums.[13] IFIs and donors have an important "counter-cyclical" role to play – increasing lending levels as private sources diminish. Sure enough, IFIs increased significantly their commitments to record levels. Assistance through IFIs also represents the main form of EU involvement to date, as it has supported IFIs in making their commitments (as a key shareholder and provider of funding), it has contributed an additional US$100 billion to the IMF, and it has accelerated the disbursement of structural funds and

[12] See also Atish R. Ghosh, et al., "Coping with the Crisis: Policy Options for Emerging Market Countries", IMF Staff Position Note (Washington, D.C.: International Monetary Fund, 23 April 2009).

[13] During this period, Turkey was the only other Black Sea country to attempt a bond issue, with a couple of Eurobond issuances for minor amounts.

enhanced balance of payments facilities for non-eurozone EU member states (among others affecting Bulgaria and Romania).

A separate but related possibility would be the establishment of "swap lines" between regional central banks and the central banks controlling key reserve currencies (e.g. the ECB for the euro and the Federal Reserve for the dollar) in order to ensure that a country may have the benefit of access to sufficient liquidity and foreign reserves whenever liquidity in global markets is constrained.[14] However, no such scheme is on the horizon for any of the countries of the Black Sea Region. Indirectly, a related development has been observed, although not for government borrowing but for certain private banks. Eurozone-based banks have accessed ECB facilities and used the financing to support subsidiaries and branches throughout Eastern Europe, as well as to renew/roll-over loans. In theory, the same effect could be achieved by sovereigns using eurozone-based banks as intermediaries to purchase Black Sea bond issues through targeted placements. It is the strategy which Greece, a member of the eurozone, has employed with Greek banks, which in turn have significantly increased their share of government bond purchases. It is a trick which is more difficult for other Black Sea countries to achieve, since they do not exercise regulatory control over eurozone-based banks, and thus have no coercive means by which to effect such purchases; they would have to entice banks suitably and the costs would surely be higher.

As for institutional frameworks that could extend support to the region, any programme of assistance would work bilaterally between country and assisting entity/donor, or if under a multilateral framework, it would probably be carried out by the EU – e.g. based in Brussels with participation most likely limited to the twenty-seven EU member states.

Such a framework could plausibly emerge if the crisis drags on, or a sudden wave of enlightened self-interest and forward thinking prescience strikes key decision makers in the EU. The reality, though, is that as things stand there do not appear to be any supranational or multilateral financial support schemes on the horizon that might include Black Sea countries.[15]

[14] The model for this would be the establishment of dollar swap lines by the US Federal Reserve for Brazil, Mexico, South Korea and Singapore in late October 2008. See "Currency swap eases emerging economy jitters", *The Financial Times,* 31 October 2008.

[15] Despite this fact, numerous proposals have been made, inter alia for a "European Financial Stability Fund". See Daniel Gros, "Collapse in Eastern Europe? The Rationale for a European Financial Stability Fund", *CEPS Commentary* (Brussels: CEPS, 25 February 2009), http://shop.ceps.eu/BookDetail.php?item_id=1804; for common Eurobonds see Paul De Grauwe and Wim Moesen, "Gains for All: A

During the current crisis, the EU has treated Eastern Europe generally (including the states of the Black Sea Region)

> as four groups: eurozone members, where they intend states to back each other, without IMF help; EU members beyond the eurozone, which will be supported in conjunction with the IMF…; future members…which could win limited backing; and countries without membership prospects, notably Ukraine, which will receive even less attention.[16]

Thus, even within the EU there is no institutionalised framework envisioned, while its support has come either in the form of ad hoc assistance to EU member states in cooperation with the IMF (e.g. Hungary, Romania) or in the form of implicit guarantees emanating from nebulous statements that eurozone countries would support each other, and/or that they would support non-eurozone EU member states in need.

Regional options

Theoretically, the Black Sea countries could coalesce around a regional institution such as the BSEC in order to seek ways to cooperate and coordinate. This could begin with policy dialogue and information exchanges, and continue with institutional cooperation or coordination of policies. As it develops, it could eventually evolve into

- institutional harmonisation measures;
- policy coordinations;
- the establishment of organisations; and
- the commitment and/or pooling of resources, such as multilateral swap arrangements.[17]

To date, there has been no such action at the regional level, other than some financial sector dialogue within the forum of the BSEC. Nor does there appear to be any discernible political will in this direction, rendering it a highly unlikely scenario.

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proposal for a common Eurobond", *CEPS Commentary* (Brussels: CEPS, 3 April 2009), http://shop.ceps.eu/BookDetail.php?item_id=1823. Nothing is near imminent at the time of writing.

[16] See Stefan Wagstyl, "Prospects hinge on global markets", *The Financial Times*, 12 May 2009.

[17] Such an arrangement would likely resemble ASEAN's Chiang Mai Initiative. For a description, see "Chiang Mai Initiative as the Foundation of Financial Stability in East Asia", http://www.aseansec.org/17902.pdf.

Alternatively, regional cooperation could focus upon the enhancement of dialogue in key sectors. Beyond finance, sectors such as transport, energy, telecommunications, trade facilitation and the environment lend themselves to discussion and exchange of information, eventually leading to coordinated initiatives to undertake projects or develop compatible infrastructure. Moreover, there exists a powerful rationale for cooperation to seek cost-effective solutions among neighbouring countries, since expected costs for infrastructure development are very high given the overall level of need. Coordinated cross-border projects could thus provide a degree of affordable stimulus in the near term, while also dealing with the longer term challenge of poor or worn out infrastructure that represents a potential bottleneck to the post-crisis resumption of healthy economic growth for most Black Sea countries.

The Black Sea Region after the crisis

Once markets are restored to functionality – globally, and in the Black Sea Region – most likely at a new more risk averse equilibrium, it will be possible to project how much "bottoming out" will occur, and to undertake measures and reforms to promote recovery, including those needed to improve competitiveness and productivity. As private sector risk aversion abates, private flows in the form of lending, direct investment, portfolio investment and remittances should pick up. However, a return to the rapid growth of the 2000-08 period would require foreign capital flows returning to the levels viewed at the peak of the boom. Such a reversal of current trend appears highly doubtful at present, as net financial flows to emerging markets have fallen sharply, with those to Eastern Europe having dropped most precipitously.[18] In addition, the global recovery period may take longer than anticipated because

> recessions associated with financial crises have typically been severe and protracted, whereas recoveries from recessions associated with financial crises have typically been slower, held back by weak private demand and credit. In addition, highly synchronised recession episodes are longer and deeper than other recessions, and recoveries from these recessions are typically weak.[19]

[18] IIF, "Capital Flows to Emerging Market Economies".
[19] IMF, *World Economic Outlook: Crisis and Recovery*, 106.

Even if the financial sector in the Black Sea Region has avoided the worst of the crisis, the region itself is mired in a painful economic slump and its most significant economic partner, the EU, has been wracked by the financial crisis. One particular concern is a declining revenue base which, unless mitigated or reversed, may have adverse fiscal and debt implications in future years if unsustainable deficits persist and become structural in nature. Additionally, the overriding influence of exogenous factors generates a high degree of uncertainty concerning the long term growth prospects of the Black Sea Region. For example, one external risk for the region's economies is posed by the ability (or inability) of the key decision making countries globally with the largest economies (such as the G20 participants) to address the crisis and its key elements effectively. An inadequate response could result in a global stabilisation eventually occurring but perhaps delayed and at a lower level of economic activity relative to the trend of previous years. Moreover, this would imply a "compressed" financial sector, which in turn would involve a substantial decline in private capital flows, less investment, lower levels of international trade, as well as scarcer and more expensive financing – due to the very large amounts governments of developed economies would need to attract in order to finance their growing deficits – and possibly renewed inflationary pressures.

Nevertheless, despite the crisis and its adverse implications, the Black Sea Region enjoys a number of competitive advantages including:

- proximity to the wealthy markets of the EU;
- favourable business environments – with improving political and economic stability;
- high quality of human capital (education, skills) at a relatively low cost.

Most countries have memories of dealing with crises during the 1990s, and this provides resilience, a wealth of experience upon which to draw, and greater flexibility in implementing policy responses than that observed in some of the wealthier but more rigid economies of Western Europe.

Furthermore, the devaluation of the currencies of most Black Sea countries will boost the competitiveness of the region's exporters, and may trigger an import substituting supply response from domestic manufacturers, as occurred in the late 1990s with countries affected by the Russian financial crisis. These factors, combined with reasonably solid sovereign fiscal and debt situations, the high trend of growth of recent years and the room for convergence towards the prosperity levels of Western Europe, suggest that the Black Sea Region may succeed in limiting some of the worst "bottoming out" effects of the economic crisis and manage to return to decent real rates of annual GDP growth within two to three years.

The open question, which will depend on global conditions and the influence of exogenous factors, is whether such growth would be on the order of either 2-3% per annum, implying slow recovery from the crisis, difficulty in reducing poverty rates and undertaking income redistribution to balance the gains of growth, and a slight and lengthy process of convergence to western European income levels and livings standards, or 4% or even higher, denoting a return to the high growth of the 2000-08 period with rapid recovery of output, declining poverty levels, and substantial convergence over time towards western European income levels with improved prospects for the benefits of growth being shared more widely.

One determinant – albeit not the only one – to the timing and extent of the resumption of post-crisis economic growth will be the health of the financial systems of Black Sea countries. Here there is cause for cautious optimism for they have by and large avoided the worst of the crisis in terms of collapses and failures, and in general the financial sector is small in comparison to Western Europe or the United States. In other words, less damage has been done to the financial sectors of Black Sea countries that in any case were smaller to begin with and thus have a smaller impact on the overall economy within which they operate.

If anything, financial sectors face greater risks from negative feedback from the economic crisis – i.e. an increase in bad loans due to the economic downturn, which in turn would put pressure on bank capital. Another risk factor, most apparent in countries with large percentages of foreign ownership in the banking sector, is of the foreign-based parent banks losing confidence in the local market or otherwise facing pressure to disengage. However, to date the opposite trend has been observed, with foreign banks re-affirming their commitment to their local holdings and providing capital as well as rolling over financing commitments.

In addition, the impending global wave of financial reform represents an opportunity for Black Sea countries to upgrade, modernise and undertake other measures to ensure that they restore their financial systems to health and can rely on them – within prudent, transparent and well-capitalised boundaries – to play the role of intermediary between savings and investment and thus assist in the development of the economies within which they operate.

Abbreviations

BNB	Bulgarian National Bank
BoG	Bank of Greece
BSEC	Organization of the Black Sea Economic Cooperation
ECB	European Central Bank
EU	European Union
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
IFI	International Financial Institution
IFS	International Financial Statistics
IMF	International Monetary Fund
SBA	Stand-By Arrangement
SME	Small and Medium Enterprise

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