Financial Liberalisation and Stability in the Balkans

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Relationship between the depth of the financial system and economic growth, investment, poverty and other indicators of the level of development of a country has been a long established fact in the economic theory[1]. Only in the last ten years, however, did the theory and empirical analysis clearly define the *causal* relationship between financial development and economic growth. Just as the development of a financial system is a significant determinant of an overall level of development of a country, so is the successful financial reform a significant determinant of success of a transition process. Bearing in mind that financial liberalisation is only one of the core elements of the financial reform, this paper will examine the recent developments regarding financial liberalisation of the Balkan transition countries, as a part of the international integration processes. Quantitative analysis of the financial liberalisation process, in the form of financial liberalisation indices, shall also be performed.

The global financial crisis has had as yet immeasurable impact on the Western economies, the most developed of which were used as a prototype for the economies of the emerging Balkan economies. This paper will examine the effects of the current global crisis on the on-going financial liberalisation processes in the Balkan countries. In the paper we will also attempt to give a preliminary overview of the connection between the currently achieved financial liberalisation level (as defined by the financial liberalisation indices) to the spread of the global financial crisis in the Balkan transition countries.

1. International Regulatory Framework for Trade in Financial Services

The boost in services' activities on international level, which started in early 1990es, demanded regulation of international trade in services through multilateral disciplines similar to GATT (General Agreement on Tariffs and Trade). The General Agreement on Trade in Services (GATS) was negotiated during the Uruguay Round (1986-1994) and is one of the major achievements of those negotiations. The reason is that the GATS is the first and only set of multilateral legally-enforceable rules that govern international trade in services. Similar to the GATT, GATS encompasses the following three elements: general rules and disciplines, Annexes to regulate sector specificities and the Schedule of Specific Commitments that show specific obligations a particular Member has undertaken in the particular services' sector in order to facilitate market access therein. Unlike GATT, GATS has a specific fourth element - a list of exemptions from the Most Favoured Nation treatment (MFN exemptions). This list shows the sectors in which the Member is *temporarily* not going to apply the Most-Favoured Nation (MFN) principle of non-discrimination (those are temporary withdrawals of the MFN principles).

As in the case of trade in goods, measures restricting trade in services actually decrease the real GDP level. Due to the specificities of the modes of supply of the services, liberalisation of particular services sectors demands liberal and transparent domestic regulatory framework that

[1] See [Francois and Schuknecht, 1999], or [Fink, Mattoo and Rathindran, 2001]. Overview of the empirical results is provided in [Claessens, 2005].

enables higher mobility of production factors, service providers and consumers. Thus, compared to the goods sector, in the case of services the scope of impact of international trade rules on domestic regulation is higher by far.

Goods and services fundamentally differ in more than one way. As opposed to goods, many services are not tangible, visible, or continuous and their production and consumption processes more often than not run simultaneously. It is this aspect of services that crucially determines the mode of trade in services and the reason that international trade in services often cannot occur without allowing for mobility of production factors – capital and labour. It is the former of these that will be discussed further in this paper.

The generally accepted definition of trade in services, as provided in Article 1, Paragraph 2 of the GATS, recognises this specific aspect of services and defines trade in services by way of four services supply modes[2]:

- *Mode 1: Cross-border Supply* - where services are delivered across the country border, the service provider is resident abroad while the consumer remains in the home country (for example, when financial credit is extended from a bank located abroad);
- *Mode 2: Consumption Abroad* - this is where the consumer travels into the country in which the services are delivered by the foreign services supplier;
- *Mode 3: Commercial Presence* - where a service supplier of one country supplies a service in another country by establishing, through foreign investment, a commercial presence in that country (e.g., commercial presence of foreign banks);
- *Mode 4: Presence of Natural Persons* - this applies to the temporary movement of individuals (which are natural, not legal persons as is the case in the previous mode) and arises where a service is delivered in a foreign market; these individuals may be independent service providers, or employed with a service-supply company.

The level of the foreign trade in services liberalisation is weighed against the restrictions of *Market Access* (MA) or *National Treatment* (NT) for each of the four service supply modes and for every service sector. Concrete liberalisation commitments of a WTO member country, defined against this framework, are entered into that country's Schedule of Specific Commitments (hereinafter: the Schedule) related to GATS. These liberalisation commitments are not quantitative in their nature and instead take form of non-tariff measures (NTMs).

Recognising particular nature of the financial services' sector, both as basic input for all other sectors and its importance for financial viability and stability of economy, specific rules were developed within the GATS framework to regulate it. As a result this set of rules under GATS became "to date, WTO GATS which sets rules for international trade in financial services and thus affects the financial sector and its stability remains the only multilaterally agreed, binding, and legally enforceable framework related to the financial sector"[3]. That is why we have used this data to measure financial sector liberalisation for WTO member countries.

GATS rules that apply specifically to financial services are found in several documents, and here we shall give a brief description of those aspects that are relevant for our analysis:

- GATS Articles XI, XII and footnote 8 to Article XVI.

[2] According to [Adlung and Roy, 2005], the estimates of the Statistical Division of the WTO Secretariat are that mode 3 (commercial presence) has more than 50% share of total service trade value, while mode 1 (cross-border supply) and mode 2 (consumption abroad) account for around 30% and 15% of the total value of service trade, respectively..

[3] [Kireyev, 2002] p. 3.

Article XI provides that 1) *payments and current transactions* shall be allowed in relation to service sectors and modes of supply where the country has undertaken commitments in its Schedule, and 2) that the country will not impose restrictions on *capital transactions* that may be inconsistent with the country's specific commitments[4].

Article XII provides that country may temporarily maintain restrictions on payments and transfers related to its specific commitments in the event of serious balance-of-payments (BOP) and external financial difficulties, or threat thereof. These are to be applied only under certain conditions and in accordance with the IMF Articles of Agreement.

- *Annex on Financial Services* (the Annex) further defines scope of application of GATS in financial services sector. The Annex defines which governmental services and measures shall not be subject to GATS rules. It provides that GATS rules do not apply to: (a) the activities of the Central Bank (CB) or other monetary authority in relation to monetary or foreign exchange policy not subject to GATS, and (b) the activities of any public entity performed for the account, with the guarantee or using financial resources of the Government, unless it allows that those activities be provided by a financial service supplier(s) in competition with such public entities.

  The Annex also provides that prudential measures do not fall under the GATS disciplines ("prudential carve-out")[5]. However, these measures may not be used as a means for avoiding commitments undertaken under GATS. Furthermore, the Annex offers definition and classification of financial services.

- *Second and Fifth Protocol* are results of the subsequent rounds of negotiations in financial services and provide for inclusion of new financial services as well as a higher level of commitments of member countries.

- *Understanding on Commitments in Financial Services* (hereinafter: the Understanding) provides further levels of commitments in the financial services sector. Although its application is not mandatory, most newly acceded members were hardly pressed and accepted it[6], as did most of the Central and Eastern European (CEE) countries that were members at the time. The Understanding offers a wide array of provisions that present significant liberalisation commitments on behalf of the signatories thereof. It is divided into four sections: A, B, C and D. Part A of the Understanding provides that countries shall not undertake any new measures that are contrary to the provisions contained therein. Parts B and C specify MA and NT commitments respectively, while part D supplies the definitions.

  In part B the Understanding relates to MA commitments and states that the monopoly rights must be listed in the schedule and also provides that the countries shall endeavour to eliminate them or further reduce their scope. This provision also applies to other governmental services (not including monetary authority). Part B further provides that modes 1 and 2 shall be allowed for the provision of insurance of goods in international transit, insurance of goods, the vehicle that transports the goods and the liabilities arising there from, in commercial aviation and maritime shipping, and reinsurance, retrocession and the services auxiliary to insurance. Most SECE countries have committed only to this part of the Understanding.

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[4] Exceptions are to be allowed only under the auspices of the IMF.

[5] This provision is quite vague in many aspects as shall be discussed in more length below. However, it provides appropriate procedures for recognition of prudential measures of member courtiers.

[6] Due to the wide scope of the Understanding it is usual that countries apply it partially, this fact being entered in their Schedule.

It also provides that mode 1 shall be allowed for provision and transfer of financial information, financial data processing etc., as well as advisory, intermediation and other auxiliary financial services, while mode 2 shall be allowed for all banking and other financial services (that includes all financial services except for insurance).

With regard to mode 3, the Understanding provides that the country shall allow financial services providers of another member to establish its commercial presence and to expand within its territory including purchase of the existing enterprises. Established commercial presence of another member shall be allowed to provide new financial services[7], as well as transfer and processing of financial information and transfer (importation) of equipment necessary for business operations of a financial services supplier. This provision stipulates an extremely high level of liberalisation and no CEE country has undertaken such commitment.

Part C of the Understanding relates to NT commitments and provides that established commercial presence of another member shall have access on NT basis to publicly-operated payment and clearing systems, official funding and refinancing facilities available (not including the lender of last resort facilities), as well as to membership of any professional bodies, associations etc..

The regulatory framework outlined above is by no way perfect, but several issues are of particular importance for further analysis of the commitments undertaken towards liberalisation of financial services sector. These are: (i) Distinction between modes of supply, (ii) Scope of prudential measures, (iii) Capital mobility issues, and (iv) Autonomous liberalisation.

(i) *Distinction between modes of supply.* One of main issues regarding definitions and disciplines defined in GATS is the unclear distinction between modes 1 and 2. This issue was identified and analysed in the WTO forums and also in the document [WTO, 2001] which examines different specificities of the financial services sector. The distinction between the two modes of supply is particularly unclear in the case of financial services sector. While the mode 1 occurs when the consumer is at the domestic territory and mode 2 when he goes abroad (in both cases the service provider is abroad) now it is often the case that physical presence of the service consumer is no longer necessary for the service provision, due to the modern telecommunication technology available. It is often hard to tell how was the particular service provided, i.e. by which mode?

The issue of distinction between the modes of supply may also be found with regard to modes 1 and 3. One study [Kono and Schuknecht, 1998] finds that in financial services sector most important modes of supply are modes 1 and 3, and in some cases the distinction between the two is quite vague. For example, a foreign bank credit that was aranged over the phone presents mode 1 of supply, while the same credit arranged through domestic branch[8] or subsidiary of a foreign bank shal be deemed mode 3.

(ii) *Scope of prudential measures.* By virtue of the Annex on Financial Services prudential measures are allowed (so-called “prudential carve-out”) and are not subject to GATS disciplines, provided they shall not be used as a means of avoiding commitments under GATS and the country’s Schedule. The WTO legal documents do not provide a precise definition and explanation of what prudential measures comprise of. From the

[7] Part D defines new financial service as a service of a financial nature, related to existing and new products or the manner of their delivery that is not supplied on the member’s territory but is supplied in the territory of another Member.

[8] Branches in this paper, same as in the WTO definitions, are dependent legal entities of a parent company situated abroad.

information available it could be surmised that they include not only measures to ensure stability and integrity of the financial system, but also measures to protect investors, depositors, etc.[9]. No further explanation is offered, which is fine since this should not be subject of the WTO[10] but other international fora, such as Bank for International Settlements (BIS), IMF or International Organisation of Securities Commissions (IOSCO). However, while prudential measures are not scheduled in the countries' Schedule still the extent of their restrictiveness may significanlty undermine the level of commitment (i.e. libersalisation) of individual members. This imposes significant reservations regarding the quality of information avaliable in the Schedule, with regard to financial services.

(iii) *Capital mobility issues.* With regard to financial services sector, capital mobility issues, namely capital and current transactions are of particular importance. It goes without saying that without opening the current account mode 1 is generally not feasible. That may be the reason many CEE countries keep this mode of supply closed. Regarding capital transactions these generally have an impact on all modes of supply. This has been discussed in more detail in [Kireyev, 2002], who has developped a table for measurement of the strength of influence of capital transactions on praticular types of services in financial services sector, and for all 4 modes of supply[11]. This table show that capital transactions are general of minor influence for all tupes of insurance services for modes 1 and 2 (except for mode 1 in life insurance services where it is of strong significance). Regarding banking and securities trading the capital flows have majror significance for alll types of services for modes 1 and 2 (except for financial leasing in mode 1). Commercial presence, that is, mode 3, in most cases does not have such strong significance[12]. Thus in most cases liberalisation of financial services is not feasible without liberalising the capital and current account. Consequently, the existing capital mobility limitations should be directly or indirectly listed in the country's Schedule in as far as they impact the financial sector commitments.

(iv) *Autonomous liberalisation.* The term "autonomous liberalisation" refers to liberalising measures undertaken unilaterally by member countries above the level of liberalisation they committed to in their Schedules. In case of financial services, these liberalisation steps were carried out either as part of the countries' ongoing economic reform or in response to international requirements imposed by regional agreements such as EU accession, OECD membership requirements or structural reforms under World Bank/IMF programmes. For example, a recent study [Barth, Marchetti, Nolle and Sawangngoenyuang, 2006] finds that in banking 33 members allowed entry through acquisitions, 44 through subsidiaries, and 36 through branching, although they have not made a commitment on that at the WTO.

The issue is how to encourage member countries to bind this higher level of liberalisation. Within the GATS framework, each member may seek concessions from its trading partners, in response for binding the higher level of liberalization. In theory, exactly that is the role of the successive rounds of trade negotiations as provided under GATS Article XIX. The Fifth Protocol, adopted on November 14, 1997 and entered into force on March 1, 1999, captures the results of the last successful round of negotiations that resulted in improvement of financial services' commitments. For our purposes it is

[9] See GATS Annex on Financial Services, section 2 (a).
[10] See for example [Key, 2003], page 12.
[11] [Kireyev, 2002] p.13.
[12] The establishment of commercial presence, of course, requires inflow of capital (FDI), but such transaction is normally not forbidden.

important to know that all CEE countries (that were WTO members) improved their financial services' liberalisation commitments in line with their applied regime.

2. Financial Services' Trade Regime in the Balkan Countries

It is common knowledge (see WTO site) that the new WTO members usually make much higher level of commitment, as compared to the older members. This comes as a consequence not only of the way the negotiations for accession are structured but also of the WTO principle of the progressive liberalisation. In financial services sector in particular there was a pronounced increase of commitments in all members regarding the scope of sectoral coverage and the level of commitments, due to the post-Uruguay rounds of negotiations that were dedicated exclusively to the financial services. Level of commitment in financial services in CEE countries, as concluded in [Mattoo, 1999], is much higher compared to other members: "5 out of the 7 (CEE) countries, accounting for 79 per cent of regional participant's GDP, already represent the most liberal markets as far as commercial presence is concerned"[13].

We have analysed commitments in financial services in 5 countries, WTO members, in the Balkan region: Albania (achieved WTO membership in 2000), Bulgaria (WTO member since 1996), Croatia (member since 2000), Macedonia (WTO member since 2003) and Romania (original member). The analysis encompassed Lists of MFN Exemptions[14] as well as Schedules of those 5 countries, but only first three modes of supply were taken into account (mode 4 was not deemed relevant for purposes of our study or for the financial services' sector *per se*).

Concrete liberalisation commitments within financial services' sectors were analysed separately for the following financial services sub-sectors, according to part 5 (a) of the Annex:

- Insurance and insurance related services, i.e. sub-sectors (i) to (iv);
- Banking services, which comprise sub-sectors (v) to (ix);
- Other financial services (securities, money broking, asset management etc), or sub-sectors (x) to (xvi).

Results of this analysis are presented in Table 1.The level of commitment in the table was sorted and outlined in the following manner[15]:

- *No commitment* is the situation where the country has not undertaken any commitment ("unbound" entry in the Schedule) or the limitations are such that in effect there is almost no market access;
- *Full commitment* is the situation where the country applies no (or practically no) limitations for market access. In case of mode 3 this includes branching;
- In between the two extremes are conditions where there are some limitations. In such cases we would usually summarily state the most stringent of the limitations applicable. For example, in mode 3 the most usual limitation is "legal form of entry" which means that the country requires a certain type of domestic legal incorporation (e.g. joint-stock company) in order to achieve domestic market access through mode 3.

[13] [Mattoo, 1999] p. 17
[14] However, no country in our pool has MFN exemptions pertaining to the financial services sector.
[15] This categorisation was developed in accordance with [WTO, 2001a].

TABLE 1. LIBERALIZATION COMMITMENTS IN FINANCIAL SERVICES FOR THE BALKAN WTO MEMBER-COUNTRIES

Country		*Insurance*	*Banking*	*Other (securities etc.)*
Albania	*Mode 1*	Full commitment only for: marine and aviation transport insurance; reinsurance and retrocession.	No commitment.	No commitment (until development of appr. prudential regulation, 2010 at the latest).
	Mode 2	Full commitment.	Limitations on capital outflow (until 2010).	Limitations on capital outflow (until 2010).
	Mode 3	Full commitment.	Full commitment.	Full commitment.
Bulgaria	*Mode 1*	Significant limitations including on capital movement.	No commitment.	No commitment.
	Mode 2	Significant limitations including on capital movement.	No commitment.	No commitment.
	Mode 3	Foreign entry only through participation in the existing companies or authorized branches. Also exclusive providers.	Limitation on legal form of entry.	Limitation on legal form of entry.
Croatia	*Mode 1*	Full commitment only for: marine and aviation transport insurance; reinsurance and retrocession.	Full commitment except for acceptance of deposits.	No commitment for trading, and underwriting and issue of securities.
	Mode 2	Full commitment only for: marine and aviation transport insurance; reinsurance and retrocession	Capital mobility limitations.	Capital mobility limitations.
	Mode 3	Full commitment.	Full commitment.	Full commitment.
Macedonia, FYR	*Mode 1*	Full commitment only for: marine and aviation transport insurance; insurance of commercially licensed transportation vehicles; and reinsurance and retrocession.	No commitment.	No commitment.
	Mode 2	Full commitment only for: marine and aviation transport insurance; insurance of commercially licensed transportation vehicles; and reinsurance and retrocession	Full commitment except for deposit services which will be liberalized upon phase II of SAA.	No commitment, full commitment will be awarded gradually to trading, with the application of SAA with the EU.
	Mode 3	Limitation on legal form of entry, branches allowed.	Limitation on legal form of entry. Branches allowed.	Limitations on legal form of entry, branches allowed
Romania	*Mode 1*	No commitment except for reinsurance of the part of the risk that cannot be placed on domestic market.	Full commitment except for payments where no commitment.	No commitment.
	Mode 2	No commitment except that ceding reinsurance on international market allowed reinsurance that can not be placed domestically.	Only with the CB permission.	No commitment.
	Mode 3	Allowed only as a joint venture with a domestic person	Full commitment.	Limitations on legal form of entry.

Note: *No commitment* – market closed (although in effect it may be open, the country did not make any obligation to keep it so); *Full commitment* – fully open market
Mode 1 – cross border trade, *Mode 2* – consumption abroad, *Mode 3* – commercial presence

The results show that the level of commitment is higher in the case of banking, compared to insurance and other financial services. This is fully in line with the findings of [OECD, 2003], which concludes that in all South and Eastern European (SEE) countries “financial services are dominated by the banking sector”.

Limitations on capital mobility are present in every country in the pool. In some countries, like Albania and Bulgaria, they are listed horizontally, while some countries have listed them in the financial services section of the Schedule (Croatia, Macedonia and Romania). Insurance sectors are more closed than other sectors. Except for an overall acceptance of the insurance-related part of the Understanding pertaining to insurance of goods in transit and in maritime and aviation, other sub-sectors of life and non-life insurance seem to be mostly closed. The exception is reinsurance and retrocession which are, as a rule, kept open in most cases.

Securities trade and other financial services seem to be the least developed. Albania even entered that it will take commitments in this sector upon adoption of adequate prudential regulation for mode 1. *Almost all countries in the pool made no commitments for the first two modes*[16], while mode 3 was kept fully open only in Albania and Croatia. Bulgaria.

The analysis of commitments in the banking sector[17] of the Balkan WTO members was used to calculate the liberalisation indices applying the methodology developed in [Mattoo, 1999]. The scope of analysis was limited to two sub-sectors in banking: (v) acceptance of deposits and other repayable funds from the public and (vi) lending of all types including consumer credit, mortgage credit, factoring and financing of commercial transactions[18]. The scope is further limited to only the first three modes of supply, the same as in the analysis in Table 1.

The liberalisation indices were also calculated for three Balkan countries that are still negotiating WTO accession: Bosnia and Herzegovina, Montenegro and Serbia. Since they are not members (hence do not have a Schedule) the liberalisation indices were calculated on the basis of their *currently applied regulatory regime*. This means that, without changing the current regime these countries cannot have a higher liberalisation index, on one hand. On the other hand, it is possible and quite probable that during negotiations for accession they may be expected to accept a higher level of liberalisation compared to their current regime, meaning that the WTO membership may result in a higher liberalisation index (effected by the regulatory change, of course). In short, results for these three countries are not directly comparable to those of other countries if the currently applied regime in those countries is significantly different to the commitments in their respective Schedules. As we conclude below, in our country pool this happens only in case of Bulgaria..

The liberalisation index created by Mattoo runs in the interval [0,1]. The situation where there are no restrictions on a particular service or mode of supply is considered the situation of full liberalisation and the index value is 1. On the other hand, if no commitments were taken for the studied service and supply mode, the index value is 0. Between these two extremes there are many levels of "partial" liberalisation, defined by particular commitments. Determining the index values for each type of restriction is based on the scale in [Mattoo, 1999] which was slightly adapted to reflect the specific features of limitations in Balkan countries. Thus, in the case of mode 3 many countries impose restrictions on legal form of entry - e.g., it is required that a specific type domestic entity be founded in order to provide banking services (i.e. no cross-border branches are allowed) and in such cases the index value is 0.75.

[16] So, although we find, same as [Mattoo, 1999] a high level of liberalisation in mode 3, modes 1 and 2 seem to be closed. The same will be found for banking services in the analysis below.

[17] The liberalisation indices could be also calculated for insurance sector, but the banking sector, as the most developed, was found to be a good representative of the overall level of liberalisation, particularly with regard to possibilities of spread of the current financial crisis.

[18] As categorised in the GATS Annex 5(a).

TABLE 2. LIBERALISATION INDICES FOR BANKING

	WTO membership	*Acceptance of Deposits*	*Lending of all Types*
Romania	1995, Jan 1	0.99	0.98
Croatia	2000, Nov 30	0.85	0.98
Macedonia, FYR	2003, Apr 4	0.85	0.80
Albania	2000, Sept 8	0.87	0.78
Montenegro	Not a member	0.79	0.81
Bosnia and Herzegovina	Not a member	0.64	0.66
Bulgaria	1996, Dec 1	0.64	0.56
Serbia	Not a member	0.21	0.29

Note: Higher levels of index indicate higher liberalization commitments; 0 signifies no liberalisation and 1 signifies full liberalisation

Information on limitations applicable for each of the 5 WTO member-countries were gathered from their GATS Schedules, in line with the analysis in Table 1 and in accordance with the model set out in [Mattoo, 1999]. For countries that are still not WTO members, as already explained, we have measured their actually applied regulatory regime. The adequate regulations that were used were:

- For Bosnia and Herzegovina: Law on Banks of Republic of Srpska[19], Law on Banks of Federation of Bosnia and Herzegovina[20], Law on Foreign Exchange of Federation of Bosnia and Herzegovina and Law on Foreign Exchange of Republic of Srpska[21];
- For Montenegro: Law on Current and Capital Transactions with Abroad[22] and Law on Banks[23];
- For Serbia: Law on Banks[24] and Law on Foreign Exchange[25].

Regarding banking subsector (v) acceptance of deposits and other repayable funds from the public, and limitations that would fall under mode 1 and mode 2 of trade in services, the appropriate legislation in Serbia and Bosnia and Herzegovina provides that only domestic banks may provide these services, in general. Domestic persons may have an account in a foreign bank only under special terms provided by the Government. Therefore, this mode is closed in these two countries (index value 0). In Montenegro, however, there are no limitations in WTO sense regarding this service and modes of supply (index value is 1).

With respect to banking subsector (vi) lending of all types including consumer credit, mortgage credit, factoring and financing of commercial transactions, and limitations that would fall under modes 1 and 2, again Serbia and Bosnia and Herzegovina have less liberal regimes. Both have only recently started to liberalise use of cross-border credits (only for legal persons and under

[19] *Official Gazette of Republic of Srpska* No. 44/03 and 74/03
[20] *Official Gazette of Federation of Bosnia and Herzegovina* No. 39/98, 32/00, 48/01, 41/02, 58/02, 13/03, 19/03 and 28/03.
[21] *Official Gazette of Republic of Srpska* No. 96/03 and 123/06
[22] *Official Gazette of Republic of Montenegro* No. 45/05 and 62/08
[23] *Official Gazette of Republic of Montenegro* No. 17/08
[24] *Official Gazette of Republic of Serbia* No. 107/05
[25] *Official Gazette of Republic of Serbia* No. 62/06

particular conditions), and have achieved only partial liberalisation in this sense (index value is 0.5). Montenegro, on the other hand, does not apply any such limitation.

Regarding commercial presence, i.e. mode 3 of trade in services, the least liberal regime is present in Serbia which still has not defined transparent rules that a bank should fulfil in order to establish its commercial presence in Serbia (index value 0.25). Both Bosnia and Montenegro have more liberal regimes in this sense, but neither allows cross-border branching (index value 0.75).

After we assigned the indices for each of the two types of services and for each of the three supply modes investigated, what we needed was a suitable means (e.g., weighting scheme) to aggregate the data. The weighting scheme, which is supposed to define the relative significance of each of the studied service categories, was calculated based on USA foreign trade data[26]. The findings of our analysis are shown in Table 2.

The liberalisation indices presented in Table 2 show that the most liberal among Balkan transition countries are the new WTO members and Romania, while the least liberal are countries that are not WTO members and Bulgaria. Since its WTO membership Bulgaria had to adapt its financial services regulatory regime to EU regulations, so it is without doubt that its applied regime is far more liberal than its WTO commitment, i.e. autonomous liberalisation occurred in Bulgaria and it did not bind this new level of liberalistion in its WTO Schedule. Hence, Bulgarian liberalisation indices for banking are not a good measure of its financial opennes; they are a good measure only of the Bulgarian WTO commitments. All other countries' indices are a good represenatation of their applied regime: for Albania, Croatia and Macedonia because they were pushed to this level of financial liberalisation during their WTO accession negotiations, for Romania because they have already achieved almost full liberalisation and for non-WTO members because the index was measured according to their actual, applied regime.

The highest impact on the liberalisation score is that of the mode 3[27]. Albania, Croatia and Romania have the most liberal regimes in this mode, followed by Bulgaria, Macedonia and Montenegro which have minor restrictions, while the least open is Serbia with discretionary licensing for MA in mode 3 (albeit the CB had been gradually relaxing this provision over the last several years).

For further analysis it is important to stress that both the descriptive and quantitative analysis performed above reflect the fact that in the banking sectors of the Balkan countries most limitations are present in mode 1, followed by mode 2. This indicates the countries' careful approach towards liberalisation worrying that it may endanger the stability of the financial system as well as to prevent the capital flight. On the other hand, for inwards movement of capital these countries mainly keep their markets open as in transition the capital is the most limited resource.

3. Impact of the Financial Crisis on Emerging Balkan Economies

Just as the emerging European countries were the fastest growing economies (apart from the emerging Asian countries) before the crisis, now they seem to be the ones most affected by the crisis. According to the IMF World Economic Outlook database [IMF, 2009] in 2007 the average annual rate of real GDP growth has dropped 0.3 percentage points for advanced economies and

[26] The main reason for deciding on this weighting scheme was the fact that the USA keeps separate statistics for each of the services supply modes. Since the same weighting scheme was used for all countries, the value of the weight does not distort individual countries' compared data.
[27] Notwithstanding because it has the highest weight in the calculation of the index.

1.2 percentage points for CEE[28] countries (see Table 3.). The same was the case for 2008, when the real annual GDP growth rate dropped on the average for 1.8 percentage points in the advanced economies and 2.5 percentage points in the CEE. IMF staff projections for 2009 point out that there could be a really sharp downturn in 2009 – they expect an additional drop of 6.6 percentage points, on average, in the annual real GDP growth rate of the CEE countries. We are of opinion that these predictions may be overly optimistic.

Of all CEE countries, the crisis hit the Baltic states the hardest (in 2008 in Latvia the GDP growth rate dropped 14.6 percentage points, in Estonia 10 percentage points, while in Lithuania the drop of 13 percentage points is expected in 2009[29]). However, there is a plausible scenario that this type of recession, with two-digit drop in GDP growth rate, could be expected in many other CEE countries as well. We shall give a brief description of factors that point in that direction.

TABLE 3. REAL GDP GROWTH RATES AND DYNAMICS, BALKAN COUNTRIES

Country		***Average 2000-06***	***2007***	***2008***	***2009***
Advanced economies	annual % change	2.5%	2.7%	0.9%	-3.8%
	annual increment	*0.4*	*-0.3*	*-1.8*	*-4.7*
CEE[30]	**annual % change**	**5.8%**	**5.4%**	**2.9%**	**-3.7%**
	annual increment	***1.3***	***-1.2***	***-2.5***	***-6.6***
Romania	annual % change	5.6%	6.2%	7.1%	-4.1%
	annual increment	*0.8*	*-1.7*	*0.9*	*-11.2*
Montenegro	annual % change	3.2%	10.7%	7.5%	-2.7%
	annual increment	*1.4*	*2.1*	*-3.2*	*-10.2*
Bosnia and Herzegovina	annual % change	4.9%	6.8%	5.5%	-3.0%
	annual increment	*0.3*	*-0.1*	*-1.3*	*-8.5*
Croatia	annual % change	4.4%	5.5%	2.4%	-3.5%
	annual increment	*0.3*	*0.7*	*-3.1*	*-5.9*
Bulgaria	annual % change	5.5%	6.2%	6.0%	-2.0%
	annual increment	*0.2*	*-0.2*	*-0.1*	*-8.0*
Serbia	annual % change	5.2%	6.9%	5.4%	-2.0%
	annual increment	*0.0*	*1.7*	*-1.5*	*-7.4*
Macedonia, FYR	annual % change	2.3%	5.9%	5.0%	-2.0%
	annual increment	*-0.1*	*1.9*	*-0.9*	*-7.0*
Albania	annual % change	5.9%	6.3%	6.8%	0.4%
	annual increment	*-0.3*	*0.8*	*0.5*	*-6.4*

Source: Annual GDP growth rates are from IMF World Economic Outlook Database
Note: Figures in shaded fields are the IMF staff estimates and projections.

In the Balkan countries (subset of CEE countries) the effects of the crisis were not as immediate as they were in the Baltic states. With the exception of Romania, no significant drop in the annual real GDP growth rate was recorded in 2007 (see Table 3.). The first substantial effects were observed in 2008, when a more significant drop in the annual GDP growth rate was perceived in

[28] According to the current IMF classification, this includes the following 13 countries: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Estonia, Hungary, Latvia, Lithuania, Macedonia FYR, Montenegro, Poland, Romania and Serbia.
[29] Calculated based on [IMF, 2009], p. 194.
[30] For a full list of CEE countries included see footnote 28.

Montenegro (albeit after a rise in GDP growth rate of 2.1 percentage points in 2007) and Croatia (-3.2 and -3.1 percentage points, respectively). They were followed by Serbia and Bosnia and Herzegovina, whose annual real GDP growth rate in 2008 dropped by 1.5 and 1.3 percentage points, respectively. However, a plummet in economic activity, as measured by GDP growth rate, is expected in this year. It is expected that all Balkan countries will have a negative GDP growth rate in 2009 (except for Albania) and that a drop in the real GDP growth will be higher both compared to the advanced country average and to the CEE average. These figures are presented in Table 3 below, where countries have been sorted by the total effect of annual GDP growth rate slowdown for the three-year period of 2007-2009.

As GDP figures for the first quarter of 2009 come out, the IMF predictions were revealed to be quite conservative. *New Europe Weekly* of May 15 [Danske Research, 2009] also warns that in 2009 GDP in most CEE countries will most likely plummet. According to this source, in Romania GDP figures for the first quarter of 2009 show that there is a Q1 year-on-year 6.4% drop, which means that even in the (albeit unrealistic) best case scenario (i.e. GDP will stop declining) the annual GDP growth rate will drop by more than 10 percentage points, while the IMF WEO prediction is that the annual GDP growth rate will drop 11.2 percentage points in 2009. The similar is the case of Bulgaria whose GDP dropped by 3.5% year-on-year in the first quarter of 2009[31]. Furthermore, while IMF predicts that GDP growth rate for Serbia will be -2% and for Montenegro -2.7%, based on the current economic trend it is our expert opinion that it should drop much more, to at least -5 to -6% annual growth rate, in both countries.

Significant secondary effects of the global crisis on the emerging Balkan economies are to be expected mainly due to the fact that their high pre-crisis growth was fuelled by rapid credit growth that was largely financed externally, loss of export markets due to the contracting demand abroad and retrenchment of foreign investors due to increased risks, coupled with the large domestic and external imbalances of these countries.

TABLE 4. EXTERNAL FINANCING NEEDS AND DOMESTIC CREDIT GROWTH AND COMPOSITION FOR SOME BALKAN COUNTRIES

	External refinancing needs in 2009 as % of FX reserves[1]	***Maturing debt in 2009 as % of FX reserve[1]***	***Average real credit growth over last 5 yrs (%, year-on-year)[2]***	***Loan to Deposit Ratio[2]***	***Share of foreign exchange loans in total loans, %[2]***
Romania	118	99	47.1	1.3	55.5
Croatia	173	151	13.1	1.1	62.0
Bulgaria	139	16	35.9	1.3	66.9
Serbia	106	73	26.2	1.2	68.0
Macedonia	114	101	n.a.	n.a.	n.a.

Sources: [1] Fitch rating agency *External Financing Risks in Central and Eastern Europe*
[2] [IMF 2009a]

On the macroeconomic front, the emerging Balkan economies face significant challenges in rolling over debt (see the first two columns of Table 4) and funding their current account deficits (see the two last columns in Table 5). According to the Fitch rating agency, all the countries in Table 4 have refinancing needs that are above 100% of their foreign exchange (FX) reserves as

[31] Due to the differences in methodology, the first quarter GDP figures for some Balkan countries cannot be used for comparison.

well as debt maturing in 2009. At the same time, as illustrated by Table 5, all the emerging Balkan economies have high current account deficits calculated as percentage of their GDP. These figures have risen significantly in 2008, even before the crisis had fully blown, reaching double-digits in all countries except Croatia (which has significant foreign currency inflows from tourism).

In the banking sector, all Balkan countries in Table 4 show extremely high average annual credit growth rates, adverse loan to deposit ratios and extremely high share of foreign exchange loans in total loans. According to data in Table 5, in 2008, in wake of full impact of the crisis in this region, all Balkan countries have experienced increased credit default and particularly Serbia (for 1.5 percentage points), Montenegro (for 1.3 percentage points) and Macedonia (for 1.2 percentage points).

The ratio of bank-related capital inflows to GDP in emerging European economies is several times higher than in other emerging economies[32]. So, the large current account deficits in emerging Balkan economies were financed mainly by borrowing of domestically established subsidiaries of foreign banks from their parent banks abroad. As already discussed above, financial liberalisation in all the Balkan countries allowed foreign bank presence, albeit under some limitations, and all banks were allowed to take credits from abroad. Furthermore, cross-border credits to corporate sector were allowed by all countries and in most cases without any limitations. The only limitations that were administered relate to capital outflow and, to some extent, type of foreign bank presence, while there were no limitations to capital inflow.

TABLE 5. NONPERFORMING LOANS AND CURRENT ACCOUNT BALANCE

		Bank Non-performing Loans to Total Loans		***Current Account Balance as % of GDP***	
Country		***average 2003-07***	***2008***	***average 2003-07***	***2008***
Romania	%	8.5	9.8[1]	-9.5	-12.6
	annual increment	*0.4*	*0.1*	*-2.0*	*1.2*
Montenegro	%	4.2	4.5[2]	-15.2	-31.3[4]
	annual increment	*-0.7*	*1.3*	*-5.6*	*-2.0*
Bosnia and	%	5.4	3.1[3]	-14.9	-15.0
Herzegovina	*annual increment*	*-1.4*	*0.1*	*1.7*	*-2.3*
Croatia	%	6.5	4.8[2]	-6.0	-9.4
	annual increment	*-1.0*	*0.0*	*-0.5*	*-1.8*
Bulgaria	%	2.3	2.4[3]	-13.6	-24.4
	annual increment	*-0.3*	*0.3*	*-4.9*	*0.7*
Serbia	%	15.6	5.3[3]	-10.7	-17.3
	annual increment	*-5.1*	*1.5*	*-2.0*	*-1.9*
Macedonia,	%	0.3	1.6[2]	-4.6	-13.1[4]
FYR	*annual increment*	*0.0*	*1.2*	*-0.8*	*-5.9*
Albania	%	3.5	4.1[2]	-6.0	-13.5
	annual increment	*-0.3*	*0.7*	*-1.0*	*-4.4*

[1] In June 2008 [2] In September 2008 [3] In December 2008 [4] Estimate
Source: Calculated upon data from IMF World Economic Outlook database

[32] See [IMF 2009b] p. 46.

Against this setting and high domestic interest rates (reflecting country risk among other factors), foreign affiliates had a preferred position as they had a cheaper source of capital compared to the domestic banks. This led to a rapid credit growth (and faster than the private sector growth), both to corporate and household sectors, frequently denominated in foreign currency, as shown in Table 4. These resources were habitually used for financing nontradables and imports of consumer goods, thus spilling into current account deficit and often inflation.

So, borrowing from parent banks to local subsidiaries and cross-border credits to corporate sector created large roll-over needs in Balkan economies. These flows were contributing to high GDP growth rates, high domestic demand, overheating of most of the Balkan emerging economies and high current account deficits. The analysis in [IMF 2009b] points out that the differences in the countries abilities to cushion these effects were visible, and in particular the countries with flexible exchange rate were most successful (e.g. Bulgaria).

While foreign affiliate banks established domestically have been most accommodating thus far, the situation could quickly be reversed. In the face of the current crisis, banks operating in emerging Balkan countries may have to face mounting write-downs and require fresh equity, while corporate sector faces large refinancing needs, further increasing the sovereign risks of those countries. In fact, sovereign spreads have already increased, by far the most in the non-EU emerging European economies[33]. In short, it is perceivable that the banks could cut exposures and rollover rates for maturing short-term credits could fall sharply which may even point out to the Asian crisis scenario[34]. The second-round effect of a prolonged recession in Balkan countries is found to be a realistic scenario[35].

While the Balkan countries authorities have been mostly proactive in their response, and the IMF loans made quickly available, in the near future the policies will be challenged by the sheer scale of resources required[36]. In any case, a severe adjustment of external imbalances seems the only possible scenario – either domestic demand would have to contract drastically or the domestic currencies would have to weaken significantly. Further enhancement of banking prudential standards is also necessary. However, neither of these are the topic of our analysis.

The above discussion on financial crisis spread to the Balkan countries does not show that differences in the level of liberalisation of financial services' sector led to differences in speed or magnitude of financial crisis. Although it is without doubt that the banking sector played a crucial role in the build-up of the crisis, the level of liberalisation *per se* did not have an influence. This comes out from the analysis of the crisis spread, which shows that the spread of contagion does not use the routes that the policy makers in non-WTO member countries keep closed (see analysis in Part 2 of this paper). The same conclusion comes from analysing the results presented in Tables 3, 4 and 5 - the effect of the crisis on GDP growth in Table 3 and various important indicators presented in Tables 4 and 5 - where countries were arranged according to their liberalisation score presented in Table 2. The exception is Romania which keeps the top position in many aspects – it has the highest liberalisation score in Table 2, the highest drop in GDP growth rate in Table 3, average real credit growth rate for the last 5 years in Table 4 and the largest ratio of nonperforming loans to total loans in Table 5.

There is a multitude of common factors that lead to the crisis spread to the emerging Balkan economies, but the actual magnitude of the crisis depends on a number of country-specific factors. This is due to the fact that although the banking sector was instrumental in importing the crisis, it was the other macroeconomic imbalances – like heavy dependence on external financing

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[33] Ibid.
[34] [IMF, 2009] p. 19.
[35] [IMF 2009b] p. 55.
[36] [IMF, 2009a] p. 2 .

coupled with large external imbalances – that spur the spread of the crisis. These were closely connected to the high pre-crisis GDP growth rates in the Balkan countries were fuelled by strong capital inflows, also leading to rising demand and overheating of the system. Policy makers in Balkan countries would be wise to start thinking countercyclical economic policy planning, which is an activity that so far has not been a part of strategic thinking in any of these countries.

4. Conclusions

- While the perspective WTO members may be wary of further liberalisation of the financial sector due to the fear of financial crisis, such fears are not well-founded. The case of Serbia shows that even partially open financial sector may be enough to import the crisis.
- High annual growth rates of the emerging Balkan economies were based on external financing sources which, once reversed, could spur the crisis. None of the Balkan countries managed to find the internal sources of growth (with a slight exception of Croatia which has high annual FX inflows from tourism).
- Short-term policies were present in all Balkan economies with respect to other macroeconomic aspects, creating external and internal imbalances that spurred spread of the crisis. These are: large current account deficits, high credit growth rates that are far above the private sector growth, high ratio of FX loans to the total loans all of them creating high dependency on external financing needs, increasing the external exposure and sovereign risk.
- Once the crisis in mature economies started, it did not spread o the Balkan countries immediately. However, due to the above risk factors, once the external funding ceased to be available, the crisis struck deeper than in other countries (two-digit drops in GDP growth rate are expected in at least some of the countries) and it is perceived that the ensuing recession will be much longer lasting.
- In the near future a quick correction of the external balances is unavoidable. It could take form of a drastic domestic demand contraction and/or significant currency weakening, either creating a serious drop in economic activity and rise in poverty in this region.

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