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The Director General

Speech by Marco Buti
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Dear Ministers, dear Ambassadors, dear Excellencies and colleagues,

I am very happy to be here at such a prestigious event and deliver a keynote speech for this panel of distinguished speakers and discussants.

I will divide my speech into 3 building blocks:

- First, I would like to set the scene by painting the broad picture of the global economic situation, the recovery and the balance of risks with some weight on the financial sector developments and global capital flows.
- Second, I will touch on how the crisis in our view has affected the Western Balkans and in particular the financial flows, the investment climate etc.
- Finally, I will take a broader view how the EU and the IFIs have been contributing to regional development in the aftermath of the crisis, what are the EU financing options in the region, how we develop our instruments and the policy setting in which we deploy them.

Let me start now with some words on the global economic situation.

I. Global economic and financial situation

The current year has been truly difficult. Its beginning was marked by the global breakdown of financial intermediation, a rapid drying up of international trade and the beginning of a major recession in most parts of the globe. Policy makers were left scrambling to avoid the slide into a sustained world-wide depression. Where do we stand now a year later?

Since the outbreak of the financial crisis, **conditions on financial markets have significantly improved**. A gradual stabilisation started in early spring and several financial indicators have now reached pre-crisis levels. This favourable trend was driven by encouraging corporate results, positive macroeconomic data, and a sustained accommodating stance of central banks.

Money markets eased considerably, stock markets rallied and corporate bond spreads narrowed leading to an unprecedented corporate bond issuance. This stabilization also helped banks and other financial institutions to secure their own viability. Massive support by governments and central banks further contributed to this.

With improvements in stabilisation of financial markets, the global economy is growing again. Trade flows are resuming, and various economic indicators point to increases in activity.

The **recovery in the EU economy began in the third quarter of this year** with a small quarterly increase in GDP [+0.3%]. Recent data are encouraging, including the Commission's November business survey results. However, it should be noted that the ongoing recovery is partly supported by the **favourable impacts of the inventory adjustment** –

with destocking coming to an end – and the **exceptional policy measures taken by governments and central banks**.

Further out, growth in the EU can be expected to firm only gradually, as domestic demand may be dampened by the need for financial deleveraging across all sectors – financial institutions, non-financial corporations, households and the government – while the labour market situation is expected to deteriorate further. The Commission autumn forecast projects EU GDP growth to be at 0.7% in 2010 and 1.6% in 2011 while the risks are balanced.

These **initial signs of a global stabilisation are not yet supported by accompanying bank lending**. Unlike in the run-up to the crisis when very rapidly rising banking intermediation fuelled the global economy, banks are now reluctant in their lending behaviour. This should not surprise us too much, as quite often bank lending trails quite considerably in early recoveries. Resumption of bank credit is key to the sustainability of the recovery.

Balance sheets of many banks are still loaded with impaired assets, and these can quickly rise if the highly indebted private sector would encounter further challenges in serving and reducing its often unsustainable debt levels.

It is fair to say that the recession may be over but the impact of the crisis is not. After all, the recession triggered by the financial crisis was the worst in EU's history. Between the first quarter of 2008 and the second quarter of 2009, EU GDP fell by about 5%. The recession is likely to leave some lasting damage to potential output depending on the policy response.

Looking forward, financial markets recovery seems fragile as it already prices in a sustained economic recovery that has yet to be confirmed. Furthermore, additional external shocks should not be ruled out. The recent 'Dubai' crisis is an example of how asset bubbles and financing problems elsewhere may affect the EU banking sector and more importantly, hit more widely the confidence in the financial sector and the economy as a whole.

Supporting the ongoing recovery is the main priority to policymakers in the EU, as the banking system remains fragile and the full impact of the financial crisis on public finances is still to come. In particular, it will be **key to design the exit strategy** in a way which balances the different concerns on growth, inflation, employment and public finances. The key words in this context are: withdrawal of expansionary policies and a medium-term strategy for structural reforms; implementation of the Stability and Growth Pact and the future EU 2020 strategy.

Let me now come to the second part of my speech and be more specific what all of this means for the Western Balkans:

II. The impact of the crisis on the Western Balkans

At the beginning of the crisis - in late 2008 and early 2009 - the economies of the Western Balkan looked very vulnerable.

Significant imbalances had accumulated during the recent years of strong growth, both, externally, in terms of sizeable trade and current account deficits, but also internally, in the form of rapidly expanding and externally financed private sector debts.

The sharp contraction of external demand led to a rapid decline in economic activity, which immediately translated into a sharp decline of fiscal revenues, while with a certain delay, unemployment started to rise.

However, so far, **the region seems to have weathered the crisis relatively well,** with – of course – important differences between the various countries.

In most countries, external imbalances have declined, as lower imports more than compensated lower exports. FDI inflows have declined, but workers remittances have remained relatively stable and foreign banks have kept their exposure in the region, thus contributing to stability in the financial sector. So far, there was no bank run and only one bank in the region (in Montenegro) had to be bailed out.

What are the reasons for such resilience? Well, there are of course factors specific to each country, but there seems to be one important common feature: **the financial sector remained rather resilient i**n practically all Western Balkan countries.

Why? There are a number of factors:

- The **financial sector in most countries is still relatively small** and relies more on **simple financial instruments**, such as domestic savings accounts than on sophisticated financing tools. This approach kept the level of what turned out to be toxic assets much lower than in other countries. All this prevented the build-up of assets and real-estate bubbles.

- As a consequence of conservative banking, the sector's **capital adequacy ratios are relatively high** in this region. Probably this also has to do with the sector's efforts to strengthen confidence in the banking system. This policy surely paid off during the last year, when, despite some tensions in some countries, the sector's soundness was not at risk.

- Furthermore, in most countries the financial sector is dominated by **foreign banks**, mainly EU parent banks, which agreed not to withdraw their funds from their respective subsidiaries. In this respect, the **IFI Joint Action Plan** played an important role in stabilising the financial sectors in this region as well as the Vienna Initiative.

- Another positive contribution came from the **policy response** of the national authorities, which in most cases **was largely appropriate**, refrained from excessive deficit spending.

- And finally, **structural reforms** which were taken in view of the EU accession appear to have strengthened the resilience of those countries against external shocks.

So, is there **room for complacency? Of course not**. Despite the so far favourable performance, there are a number of **substantial risks in the short-term**. For example:

- **Negative feedback loops** from the real sector to the financial sector might still hit the banking sector, or

- **financial flows into the region might decline further** or they might not recover in the short-term.

In addition to those risks of short-term turbulences, there are **substantial medium-term challenges**. So far, most of those countries are still at the very beginning of their catching-up process. After decades of neglect, public infrastructure is in high need of modernisation, in many countries, the capital stock is outdated and the level of human capital is rather low. As a result, productivity is very low and unemployment is very high.

This will require sizeable financial efforts on the side of the governments in the region as significant medium-term financing is needed to speed up the convergence process. Otherwise, there might be a serious risk that some countries or the region as a whole might fall back into stagnation

To sum up:

While the global downturn had a sizeable impact on the Western Balkans, the financial sector was less exposed to those global turbulences. However, there are still important crisis-related risks, such as negative feedback loops from the real sector to the financial sector or a drying-up of financial flows into this region.

Despite important progress during the last years, there are still **significant short-term and medium-term challenges** ahead on the region's path from cooperation to EU accession, requiring full commitment and action from the governments in the region.

The European Union and the international financial institutions play an important role in supporting this transition process, by providing an anchor for the domestic reforms and financial and technical support. This already leads me to the third and last part of my speech.

III. The EU and IFI contribution to the region

The European Union provides a political contribution and guidance to Western Balkans countries, not the least through the EU perspective. The alignment of their legal systems to the *acquis communautaire* not only accelerates the modernising of their legal and institutional set-up, but also brings these countries in line with European standards which facilitates economic integration and accelerates the catching-up process.

To give you some concrete examples: In the economic area, the European Commission is having **annual economic dialogues** with all countries in the region. Furthermore, there are a number of instruments which foreshadow reporting obligations, once they are members, most notably the **medium-term economic and fiscal programmes and fiscal notifications**.

Another important tool are the annual **Progress Reports**, in which the Commission assesses country progresses with respect to meeting the accession criteria.

Financial and technical support

As you probably know, there are currently mainly 3 channels through which EU support flows into the region.

(1) First, there is **regular, accession-related support** in the framework of the so-called "Instrument for Pre-accession Assistance" **(IPA).** (EUR 11.5 Billion for the period 2007-2013).

(2) Second, there is **specific crisis-related support**, taking place in the framework of both IPA and Macro-financial Assistance **(MFA)**.

(3) Finally, the EIB and the EBRD, alongside other European bilateral institutions and IFIs such as the World Bank and the IMF, provide considerable support in financing investment projects in the region. In this context, the Commission has been instrumental in setting up a platform of cooperation through the Western Balkans Investment Framework.

As regards the **general IPA assistance**, the EU medium-term financial support is directed to areas where needs have been identified in the annual Progress Reports. Such areas notably include institution building, improving the business environment and infrastructure.

Coming to the **Union's crisis-related financial support**, this consists of:

- 200 million euro in grants from IPA have been allocated to support the banking sector, energy efficiency, SMEs and job creation, including in rural areas. These grants will leverage investments for at least EUR 1 billion of IFI loans (notably EIB, EBRD).

- Exceptional financial assistance is being made available to some pre-accession countries that sought an IMF programme to weather the crisis. This takes the form of:

  – EUR 100 million budget support **grants** in 2009-2010 financed from IPA for Serbia (Bosnia did not request such assistance);

  – two macro-financial financial assistance **loans** of EUR 100 million (Bosnia and Herzegovina) and 200 million (Serbia), approved by the Council on 30 November and expected to be disbursed in 2010, to meet both countries' residual external financing needs, as identified in the IMF programme.

All in all since the year 2000, the EU financial support to the Western Balkans through IPA and Macro-Financial Assistance amounted to about € 6 bn, which per year on average is about 1% of the region's GDP.

As regards **the IFI contribution to investment in the region**, I would like to highlight the unprecedented co-operation with the IFIs which has become even closer in the times of crisis. The EIB, the EBRD and the World Bank will certainly explain in more detail their involvement in the region.

In this context, I would like to welcome the establishment of the Western Balkans Investment Framework (WBIF) which will be signed today. It marks an important milestone in EU pre-accession policy. I am convinced that this framework will be a very effective tool to address the huge investment needs in the Western Balkans and thus support the general socio-economic development of the candidate and potential candidate countries in the region.

Close cooperation between the Commission, the EIB, EBRD, the Council of Europe Development Bank and bilateral financial institutions is necessary in order to strengthen the project pipeline and proceed with the implementation of the Western Balkans Investment Framework, which builds on the experience acquired under the Infrastructure Project Facility, now fully integrated in the framework. This will be supported by a website which serves as a single entry point and provides a unique source of information for potential beneficiaries in the region

More efforts are needed from the Commission and all the parties involved further streamlining the number of facilities dedicated to the region and bringing them under a common umbrella, in to move towards a fully fledged Framework.

As part of the response to the crisis, the EIB, together with the World Bank Group and the EBRD, launched a **Joint IFI Action Plan** in February 2009 pledging to deliver assistance of up to €24.5 bn in 2009-2010 to support the banking systems and lending to the real economy in Central, Eastern and Southern Europe.

While there is an unprecedented collaboration between different stakeholders in place, I am happy to see that the Commission plays an important role in this context not only as the biggest grant provider, but also by providing general guidance in order to meet the strategic priorities of the Western Balkan countries.

What are the lessons so far? The countries need to maintain prudent fiscal and monetary policy and continue financial sector surveillance.

Looking ahead, the challenges are not fundamentally different in the EU and the Western Balkans but rather show communalities: in the short term, the focus is on designing the exit strategies. In the medium-term, the focus is on boosting growth, adjustment and productivity.