The Black Sea region: Challenges and Lessons of the Global Financial Crisis

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This thesis aims at analyzing the economic situation in the Black Sea region. Despite significant differences between Black Sea economies in terms of their scale, set up and level of economic development, it is still possible to identify problems and challenges that are typical for all or for most of the Black Sea countries. Apparently, the global financial and economic crises have had a painful impact on socioeconomic development of the Black Sea region and its countries.

This thesis attempts to identify common crisis risk of the Black Sea region, including budgetary, investment, demographic and other risks, and to justify the need for correlation of national and regional approaches to ensure sustainable development of the economies and their capacity to face this and future crises.

The Black Sea region has ever been in the focus of international community primarily as 'a strategic bridge connecting Europe with the Caspian Sea area, Central Asia and the Middle East'[1] and as a region with significant economic and cultural potential. Unfortunately, no effective economic integration projects have been implemented in the region so far. Yet the Organization of the Black Sea Economic Cooperation is approaching its 20th anniversary very soon.

The balance of almost two decades of establishing and developing economic cooperation between the countries[2] and within the region is diverse and controversial. This is a reason to reflect on the achievements, identify a development strategy for the nearest future, and in the same time draw up a clear picture of what are the risks and challenges that the Black Sea region would face next year and afterwards.

In the Black Sea economy and social environment, 1990s saw emerging and development of new independent states, sometimes accompanied by conflicts. That was a period of transitional changes against the background of hard recession (decrease of GDP by 20%[3] and respective drop in employment and income rates in 1991-1994). Subsequent persistent depression in 1995-1999 widened the poverty-stricken zone and triggered labour migration from 1995 and on.

Most economies and population of the region adapted to the new market environments in 2000. In 2000-2001 the region actually overcame a turning point in its post-crises development. GDP started to grow; unemployment rates stabilized; positive changes

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[1] European Parliament resolution of 20 January 2011 on an EU Strategy for the Black Sea - 2010/2087(INI) (http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P7-TA-2011-0025+0+DOC+XML+V0//EN&language=EN)

[2] For the purposes of this thesis, the Black Sea region means countries that are members of the Black Sea Economic Cooperation: Albania, Armenia, Azerbaijan, Bulgaria, Georgia, Greece, Moldova, Romania, Russia, Serbia, Turkey, and Ukraine.

[3] UNCTADstat, calculations made by the author, BSTDB Annual Report 2010, p. 11, (http://www.bstdb.org/)

benefited industry, agriculture and construction sector, investment and export dynamics, salaries and social welfare. The poverty zone shrank and its rate decreased.

In 2000-2008, all countries of the Black Sea region showed sustainable development rates, with GDP increase averaging 6% per annum, equal to a cumulative real expansion of 68% for the period, with increased trade and investment, decreased poverty rates and possibilities for better livelihoods.[4] The magnitude and scale of the possibilities for each country mainly depends on how the economic growth is achieved, since it is not the growth rate but the growth quality that is important, just as human health and life expectancy depend not only on the quantity of food but rather on the quality of the diet.

Let's have a look at the regional GDP makeup by sources and GDP use.

Table 1

Black Sea GDP Makeup, %[5]

	1995	2000	2005	2006	2007	2008	2009	2010	2011
Gross domestic product (Growth Rate)	99.9	107.5	106.2	107.2	106.6	105.4	93.7	3.8	3.5
Total value added	93.2	90.6	88.1	87.8	87.5	87.4	88.9	...	...
Agriculture	9.7	8.4	6.6	5.8	5.1	5.1	5.5	...	...
Industry	34.0	29.3	28.5	28.8	28.5	28.1	26.2	...	...
Services	49.5	52.9	53.0	53.3	53.9	54.1	57.2	...	...
Net Taxes	6.8	9.4	11.9	12.2	12.5	12.6	11.1	...	...

As seen from the table, most of the GDP has been and is generated by services (including paid services provided by governmental agencies) as well as by taxes on commodity and import.

Increased share of services in the GPD makeup in many countries of the region (Armenia, Azerbaijan, Georgia, Moldova, etc) is not at all a sign of high development of this sector but rather a reflection of general problems of economies. In these countries, services primarily include trade, financial transactions and so called non-market services. All these only formally create added value whose increase actually reflects the rising income of those engaged in the sectors as well as the margin for the services, either trade or financial. In its turn, trade development strictly depends on external conditions, namely, on the 'weight' of labour migrant revenues. The scope of non-market services (public administration, education, health care) to a large extend depends on budget expenditure/budget capacities.

The commodity share in the regional GDP as well decreases annually: from 40,7% in the *crisis year* of 1998 to only 33,3% in the *pre-crisis* year of 2008. In the same time, the increased industrial output mainly comes from export-oriented sectors.

Sustained long-term growth of key macroeconomic indicators in all Black Sea countries created the 'illusion' of sustainable development of the economy in general. In most countries of the region, rising wages and social payments, increased private sector borrowing levels, etc., occurred against the background of basic economy sectors– industry and agriculture - persistently lagging behind the GDP growth.

It is remarkable that despite strong differences between the countries, significant inflow of funds (investments, transfers, etc) to the region actually did not minimize inequality. The gap in the human development index is between 9,5% in Serbia and 22,5% in Turkey. It is also

[4] A 2020 Vision for the Black Sea Region. A Report by the Commission on the Black Sea, p. 31, (www.blackseacom.eu)
[5] UNCTADstat, calculations made by the author.

clear that the money has increased imports and influenced prices.[6] *Hence the overall 'defect'* in domestic demand – it is primarily ensured by the well-to-do population.

That resulted in sustainable slowdown of economic dynamics and accumulation of internal and external imbalances such as rising inflation and current account grown deficits, and a growing dependence on continued inflows of external financing.[7]

Such factors are an undisputed motivation for structural reforms but not a dire threat to economic growth under normal conditions. Yet in financial crisis and panic-like risk aversion that gripped financial markets that growth pattern provoked collapse of most Black Sea economies.[8]

Contraction of European markets that are key for the Black Sea region, reduced foreign demand for regionally produced goods (those produced by processing industry are primarily uncompetitive), while declines in prices of raw goods, including energy carriers, further aggravated the situation.

Effects of the crisis, though different in their strength and scope, were experienced throughout the entire Black Sea region. In all the countries, except for Azerbaijan, the dropdown of the real GDP started in first months of 2009, peaking in the mid-year, and the regional GDP decreased by 6,3%. Biggest dropdown of production was recorded in Ukraine (-15,1%) and in Armenia (-14,2%).[9] Bankruptcy of businesses, growing unemployment, expanding poverty zones – that was an incomplete list of problems that everyone had to address.

In all countries of the region the crisis affected *balancing of budgets*: decrease of revenues together with increase of expenditure necessary for crisis recovery (support to business and population). Attempts to support economies using budget funds, primarily *borrowed ones*, resulted in sharp increase of foreign debt. 'Manual' management of the crisis proved ineffective and widened chances for subjectivism (corruption).

It may be assumed that the main objective of most Black Sea governments is to fit expenses into existing resource-limited revenues (cutting down expenditure is easier than creating conditions for boosting revenues to reimburse them). This approach would inevitably cause difficulties with implementation of social commitments, and not only in crisis. In a certain sense, key problem of a number of economies (e.g. Moldova, Russia and Ukraine) was not the crisis and not even the sectoral imbalance sectors since 1990s. *The key problem was that government's assumptions and hence actions in the field of economy practically did not tie into the economic realities*. There also remains the danger that the budget imbalance may become structural and may set back recovery.[10]

Timid post-crisis recovery of Black Sea economies started in 2010. There was a positive tendency towards the growth of key macroeconomic indicators: GDP, industrial output and cost of exports and imports. Investment demand grew steadily, real economy sector borrowing, increasing consumer activity, mobilizing labour market, positive trends at the credit market. According to annual outcomes, mainly because of the low baselines, the GDP growth in the region again reached almost 4% per annum. BSTBD forecasts continued positive trends towards recovery of the region's most economies for 2011, with expected GDP growth of 3,5%.[11]

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[6] http://hdr.undp.org/en/statistics/ihdi/
[7] BSTDB Annual Report 2009, p. 13, http://www.bstdb.org
[8] BSTDB Annual Report 2009, p. 14, http://www.bstdb.org
[9] UNCTADstat
[10] BSTDB Annual Report 2009, p. 21, http://www.bstdb.org
[11] BSTDB Annual Report 2010, p. 11, http://www.bstdb.org

It is notable that the indicators conceal serious differences in the quality and rates of recovery between countries. As mentioned earlier, in 2000-2008 trends were similar in all countries of the region, growth rates and quality, its dependence on foreign financial injections, hence its efficiency seriously differed. These are the differences that largely cause different rates of recovery in the Black Sea economies.

There is no single answer either at the regional or country level as to what would happen after the crisis. Yet one may identify *key challenges* of the current period for the Black Sea region as a whole and its member countries:

1. High risks of long recession of the European/global economies, destabilization of financial and commodity markets and hence decreased financial inflows to the region (investments, credits, etc.) and new contraction of demand for the Black Sea commodity (export).

There is an issue of investments/innovations: export is a motivation for innovations. Attraction of foreign investments, primarily FDIs is a prerequisite for large-scale change of the export that is less diversified by its structure. Own technological and financial capabilities of most of the countries in the region are very limited.

2. Strengthening competition for financial resources. Inflow of large assets to the Black Sea countries is unlikely in the nearest future.[12] Most countries of the region have low investment ratings because of high country risks, limited markets and unfavourable business environment.

In the years of the crisis the average FDI inflow to the region has decreased almost two times, also four and three times in Moldova and Georgia, respectively. Per capita indicators are even more painful. The volume of per capita investments in the Black Sea region is USD 2,580 (2010), which is lower than the average global indicator and five times lower than the average per capita investment rate in the EU.

Expert evaluations are sometimes very controversial.

In the World Bank's Doing Business rating, Black Sea countries (Armenia, Georgia, Moldova, etc.) have belonged to reformer countries in the several recent years. In the same time it is the character rather than consistency, of reforms that usually determines their efficiency, which slows down approximation of Moldova to the 'frontline' and reduced investment attractiveness of the country and the region as a whole.[13]

Traditional gaps in competitiveness in all Black Sea economies according to the Global Competitiveness Report of the World Economic Forum (GCI WEF)[14] are weak institutions, low quality of infrastructure, lack of skilled labour, low efficiency and development of the financial market, also business sophistication. Deficient business sophistication and regulation result in low business activity.

Azerbaijan is leading among Black Sea economies (57th place). All the countries of the region show the tendency of moving down the list. As mentioned in the GCI WEF report, pillars such as institutions, macroeconomic environment, goods market and labour market efficiency, business sophistication and innovation potential have deteriorated compared to 2008. Only two pillars showed some improvement: Health and Primary Education as well as Technological readiness. As previously, corruption was identified as the main obstacle to business development in the region, yet pre-crisis dissatisfaction with inefficiency of the state administration and tax regulation yielded to the problems of access to funding and political instability.

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[12] Transition Report 2011 "Crisis and Transition: The People's Perspectives; www.ebrd.com/transitionreport/

[13] Doing Business in a More Transparent World, p. 10, http://www.doingbusiness.org/

[14] The Global Competitiveness Report 2010-2011. The report analyzes 139 economies by 12 key indicators (institutional environment, infrastructure, macroeconomic stability, innovation potential, etc)/

Non-competitiveness of economies, together with their openness and, for most of the countries, limited capacity of the domestic market, are *a risk and a challenges for the Black Sea countries,* seriously interfering with their responsiveness to external instability.

3. Competition for qualified labour. In the struggle for macro-stability, the focus has shifted from ensuring effective employment towards achievement of acceptable statistical indicators in the area of employment.

Harsh budget policy of today and nearest future (adjusting state budget commitments to real capacities of the economy) against the background of significant social inequality and high level of corruption that are typical for all countries in the region, also significant flows of either irregular or semi-regular labour migration to a certain extent provoke shadow employment. Informal sector (without any legal contractual relations between the employer and the employees) presumably employs up to one third of the working population.

In essence, the adaptation mechanism of 1990s is being revitalized, with crisis burdens shared by all employees through cut down wages, which results in deterioration of the human capital and conservation of ineffective jobs.

In the same time, in most Black Sea countries even *an employed person* could be considered as almost unemployed by his/her income*: about 20% of the population in the countries, and almost half of the population in Armenia, Azerbaijan, Georgia and Moldova live beyond the 'national' poverty level.*[15]

Demographic issues are of national character, though unfavourable forecasts are made for all countries of the Black Sea region, which is further aggravated by loss of labour due to long-term unemployment: loss of qualifications occurs on average a year after forced unemployment and unsuccessful job-seeking.

In near future *the number of people who can work could decrease, becoming a key challenge for most countries of the region. Influence of negative demographic trends on sustainable development of economy may be multifaceted, including level of business activity, sustainability of the system of pensions, etc.*[16]

4. Strengthening distrust to the authorities and to their ability to ensure financial stability and return to sustainable development.

Practically all countries of the Black Sea region formed a significant segment of economy that is self-regulating, irrespective of governmental or legislative changes. On the one hand, this is a negative factor that sets back economic development On the other hand, the self-regulating segment relaxes the internal and external impact of the crisis, as a large part of the economy has learned to survive by all means.

Nevertheless, it is very likely that, should events of 2008 repeat, the Black Sea countries would run a very little chance of avoiding the then scenario.

It is necessary to realize that a combination of the national and regional approaches would be necessary for actions to ensure sustainable development of economies and their resilience to crisis now and in future would require.

The national dimension includes:

> Implementation of *measures to harmonize* the legislation and its enforcement mechanisms with the European standards and norms;

[15] Report on Human Development 2010, *The Real Wealth of Nations: Pathways to Human Development*, UNDP, Moscow, *Ves Mir* Publishers, 2011/

[16] Panagiotis Gavras, «The Current State of Economic Development in the Black Sea Region», Policy Report I, p. 16, (www.blackseacom.eu)

Normalization of relations between the government and the private sector, improvement of the *business environment* (competition, taxes, regulations), including the investment climate, both for foreign and local economic agents;

Structural changes in the industry sector benefiting more labour-demanding and less resource-demanding productions;

Reconstruction of the agrarian and power sectors;

Export capacity building, export diversification, and search for new markets;

Accumulation of domestic savings and support to inflows of capital and new technologies.

Regional dimension ('long-term' measures) include:

Coordination of positions regarding the concept/strategy of the 'Black Sea dimension'.
Common understanding of the region's future would support implementation of regional-scale projects, including infrastructure-related projects, using public-private partnership mechanisms. This approach would link resources and capacities of the government, regions, business, minimize risks of project stakeholders, identify scopes of responsibilities, and agree on interests.

Cooperation in innovations.
Based on national priorities, consolidate efforts in directions that determine innovative specialization of countries in the world's economy. This would possible if institutional and other conditions were created for introduction of high technologies, also if administrative barriers were removed on the way towards innovative business, capital were attracted to high-tech productions. This would require establishing an effective interaction mechanism to identify mutually beneficial innovative projects with high probability for commercialization.

Creation of 'growth poles' – fostering efficiency and using capacities of existing euroregions to achieve a new degree of economic integration.