Chapter 2: Macroeconomic Developments and Policies[1]

BOOM, BUST, AND THE AFTERMATH

This chapter reviews macroeconomic developments in the Western Balkans over the past 15 years. The countries of the region underwent substantial changes as they made the transition toward a more market-oriented model. In terms of the external environment, the period is dominated by two events: the introduction of the euro in 1999, and the financial crisis that swept across the globe starting in 2007. The euro brought further integration of capital markets in advanced EU economies; the global financial crisis interrupted capital flows significantly. For the Western Balkans, which had substantial capital needs, both events were very significant.

The confluence of these domestic and external developments prompts a number of questions. Did the Western Balkans improve their macroeconomic situation during the 2000s compared with the turbulent 1990s? What was the experience in the Western Balkans before and after the global financial crisis? Did these economies experience the same capital-led booms and busts as the New Member States, or if not, how and why did their experiences differ? And what now is the right course for macroeconomic policy in these economies?

The Western Balkan economies came into the new century after a decade of conflict, tumult, and disruption. Macroeconomic stabilization was a priority. On those terms, the past 15 years—even including those following the financial crisis—have been manifestly better than the 1990s: growth rebounded, investment returned, and inflation was sharply reduced.

Like other Emerging European economies, the Western Balkans experienced strong growth before the global financial crisis, fueled by bank credit and direct foreign investment; growth then declined as the crisis caused tighter credit conditions (Chapter 3). Across Emerging Europe, postcrisis recovery has been slow. But the experiences notably differ in degree and timing. The scale of the boom and the severity of the bust were, for most of the Western Balkans, smaller than in most New Member States, especially the Baltic States. Across the Western Balkans, the boom peaked later and the recession was less severe. But the recovery has also tended to be feeble, and crisis legacies—high unemployment and nonperforming loans on banks' balance sheets—have yet to be addressed in this region.

Were the experiences in the Western Balkans different because of policies or fortune? To some extent, luck played a role: booms in the Western Balkans were mostly less intense because they started later, from a lower level of financial development, and were curtailed at an earlier stage. Up until about 2006, these economies were less reliant on the "hot" bank lending that funded many other Emerging European economies.

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Across Emerging Europe and including the Western Balkan economies, inflation was relatively subdued until 2006–08, though capital inflows were associated with widening current account deficits and rising domestic credit. As with most other Emerging European economies, buoyant public revenues in the Western Balkans facilitated greater spending; in hindsight, fiscal policies were not sufficiently tight.

The recovery from the crisis also differs notably. Although recessions were less severe in the Western Balkans than in the New Member States, recoveries have been weak, associated notably with sluggish export performance and leading to a greater degree of import compression. In this case, fiscal policy does not appear to have been the culprit: while procyclical, it was not more severe on average than in New Member States.

The weak recovery raises questions about policy frameworks going forward. Clearly, macroeconomic conditions in the Western Balkan economies are more stable than they were in the 1990s; hyperinflation is a thing of the past. However, the legacies of public and external debt have created pressures to reduce leverage. In countries where exchange rates are fixed, flexibility of the real economy is paramount—the comparative difficulty of the Western Balkan economies to adjust real exchange rates by adjusting real costs focuses attention on the need for further progress on structural reforms (see Chapter 1).

This chapter is structured chronologically. Section A recaps the steps that the Western Balkan economies took to achieve macroeconomic stabilization in the 1990s. Section B analyzes the experiences in the years before the global crisis. The aftermath of the financial crisis is presented in Section C, and Section D concludes with a discussion of lessons for future policies.

A. Background and Context—Macroeconomic Stabilization in the 1990s

As with most Emerging European economies, the Western Balkan economies faced a huge challenge to modernize in the 1990s. But in the Western Balkans the task was tougher. Albania, for example, was nearly completely autarkic at the time it began to open up from its self-imposed isolation in 1991. Political fracturing of Yugoslavia, conflict (on the territories of today's Bosnia and Herzegovina, Croatia, Kosovo, and Serbia) and civil unrest (Albania, FYR Macedonia) dominated the decade. Some economies also faced sanctions (Yugoslavia) and blockades (FYR Macedonia).

The result, in macroeconomic terms, was that difficult starting positions became much worse. Sizable amounts of physical capital were destroyed, and trade—which had been large within the Yugoslav Federation—collapsed. Most economies experienced severe recessions at some stage: -28 percent in Albania in 1991, -8 percent in Croatia in 1993, -11 percent in Serbia in 1999, and -8 percent in FYR Macedonia in 1993.[2]

[2] These data are from the IMF's World Economic Outlook. Data are mostly incomplete; there may have been worse recessions during the 1990s for which there are no official data.

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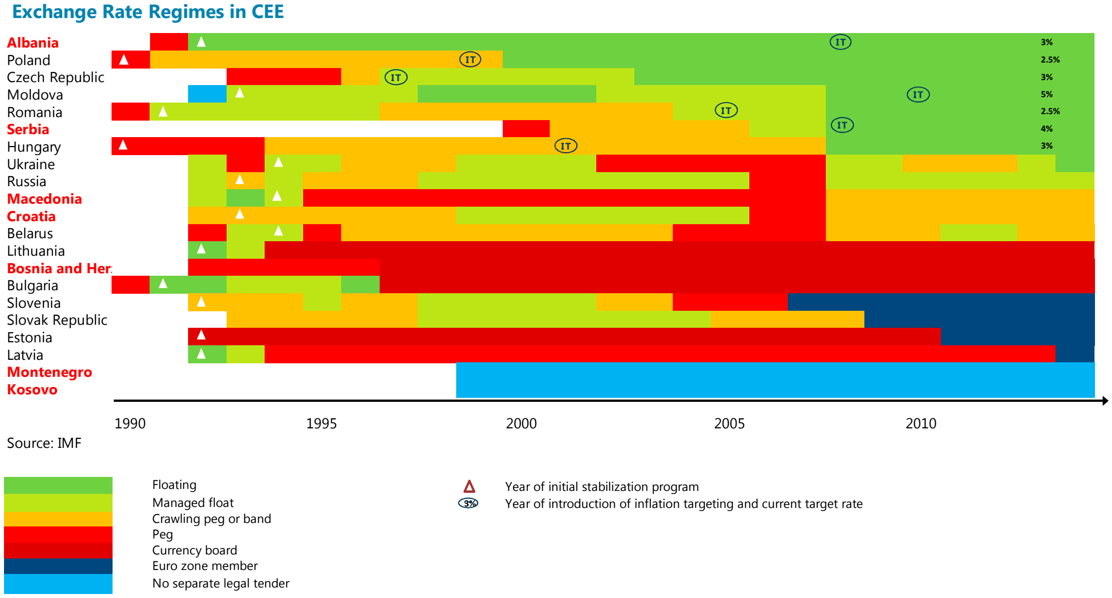
As in other transition economies, inflation rose quickly, following price liberalization, substantial increases in administered prices, exchange rate devaluations and, in some cases, passive monetary financing of growing fiscal deficits. Consumer price inflation reached over 225 percent in Albania in 1992; after hyperinflation earlier in the 1990s, it was still in high double digits in Serbia and Montenegro by the end of the decade.

A key policy issue for the Western Balkan economies was the choice of monetary regime. Most adopted some form of fixed exchange rate regime—Croatia had a managed float; FYR Macedonia chose to peg, originally against the deutschmark; Bosnia and Herzegovina introduced a currency board; and Montenegro and Kosovo unilaterally adopted the deutschmark, and later the euro. The exceptions were Serbia, which lacked a clear monetary regime until the end of the decade, and Albania, which adopted a floating exchange rate, albeit with a deliberately tight money policy (McNeilly and Scheisser-Gachnang 1998).

Exchange Rate Regimes in CEE



By the start of the new millennium, the Western Balkan economies had stabilized considerably. Although behind in terms of transition reforms and income levels, median growth in 2000 was as high as in the New Member States, and median inflation was lower. Growth was expected to persist, at around 5½ percent in real terms. In addition to these "pull" factors, "push" factors also played a role: interest rates in Western Europe fell steeply with the introduction of the euro and created the conditions for capital inflows to emerging economies, including the Western Balkans.

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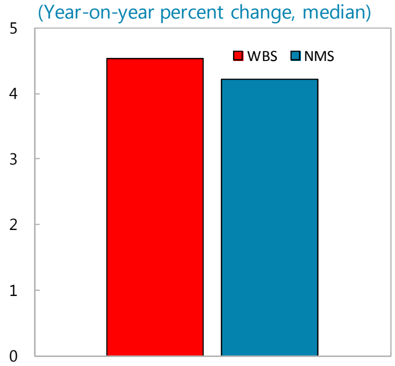
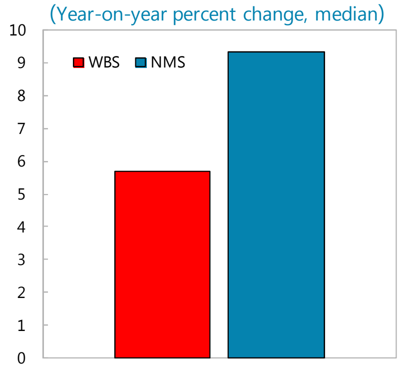
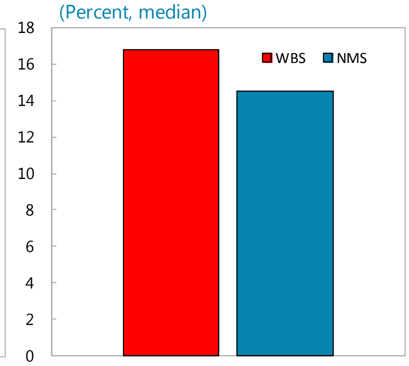
Growth Rate, 2000
(Year-on-year percent change, median)



Inflation Rate, 2000
(Year-on-year percent change, median)

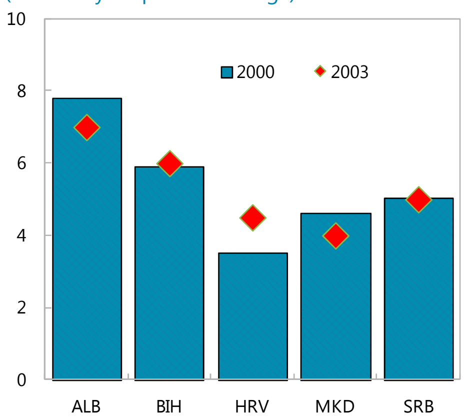


Unemployment Rate, 2000
(Percent, median)



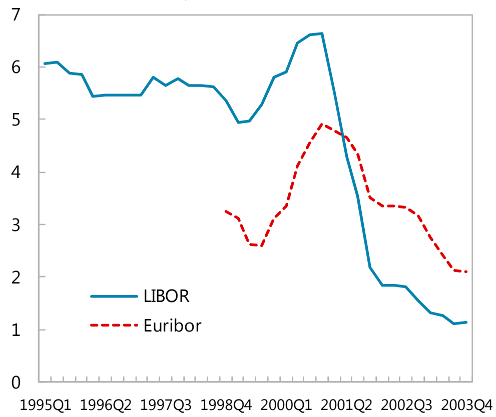
Source: IMF, World Economic Outlook.

Real Growth Expectations[1/]
(Year-on-year percent change)



Source: IMF staff estimates.
1/ Growth expectations from the IMF's October 2000 WEO.

Interest Rates
(1-month rates, percent)



Sources: Bloomberg and Federal Reserve Bank of St. Louis.

B. Before the Global Financial Crisis: Optimism and Inflows

Once peace was restored in the region, the Western Balkans embarked on a period of economic transformation, growth, and convergence, as discussed in Chapter 1. The IMF was closely involved with this transformation (see Box 2.1). But the 2000s were also the years of global optimism and large capital flows to emerging markets around the world. How did this affect the macroeconomic performance of the Western Balkan countries?

In standard theory, capital account liberalization would allow more foreign inflows, investment, and rapid growth in the capital stock, ultimately raising living standards (Obstfeld and Rogoff 1996). But, as is well known, in practice sharp increases in capital inflows have often been associated with misdirected credit, absorption as consumption instead of investment, price and asset inflation, and deteriorating competitiveness (Kaminsky and Reinhart 1999). This section thus starts with the evolution of external balances in the Western Balkans, and then documents pressures and distortions.

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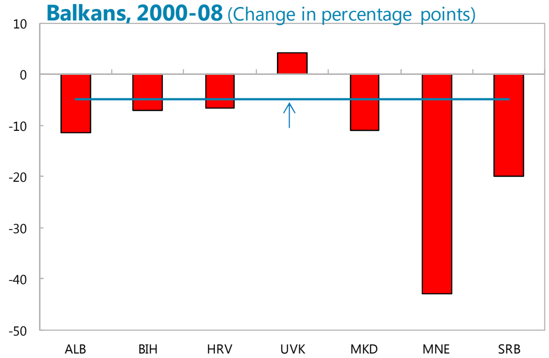
External Balances and Capital Inflows

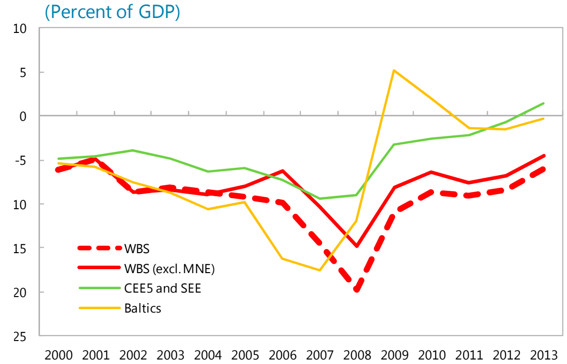
During the precrisis years, demand for new capital in Emerging Europe met a willing supply from Advanced EU economies, stimulated by declining interest rates, low global volatility, and the anticipation of rapid growth. In the case of New Member States, geographical proximity and relatively cheap labor allowed these economies to become part of an integrated cross-border production chain. From about 2003 onward, however, growth in most of these economies was driven increasingly by domestic demand, fueled by capital inflows. Capital flows through banks from Advanced EU economies were particularly important for intermediating bank credit (Chapter 3). The domestic demand boom was associated with widening current account deficits and, in later years, a pick-up in wage costs and inflation (IMF 2010b; Bakker and Klingen 2012).

Current Account Balances in the Western Balkans, 2000-08 (Change in percentage points)



Sources: IMF, World Economic Outlook and IMF staff estimates.

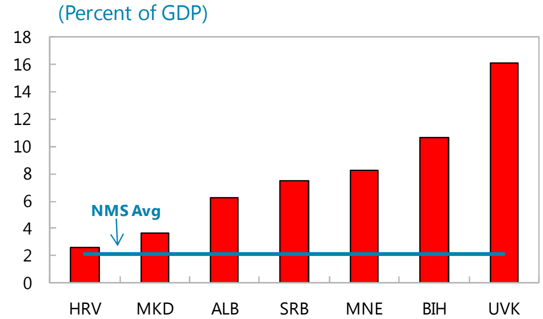
Current Account Balances by Region
(Percent of GDP)



Sources: IMF, World Economic Outlook and IMF staff estimates.

Did the Western Balkans share the same experiences? Although they started with similar external imbalances as the New Member States in 2000, the Western Balkan economies experienced on average a much larger deterioration in their current account balances. This is true even excluding the exceptionally large deficits run up by Montenegro, which reached almost half the country's GDP in 2008. Nevertheless, the experience varied: for example, Kosovo modestly improved its current balance over the same period, benefiting mainly from increasing remittances from abroad.

Remittances, 2013
(Percent of GDP)



Sources: World Bank; national authorities; and IMF staff calculations.

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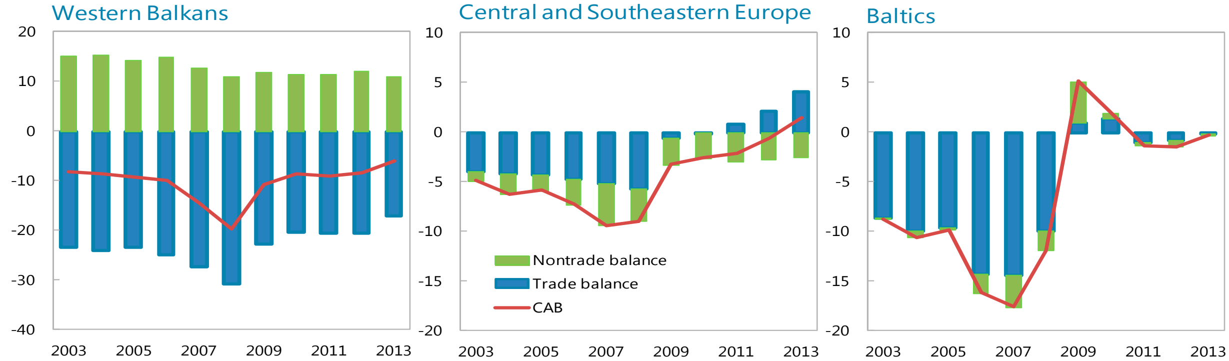
Trade Balances by Region
(Percent of GDP)

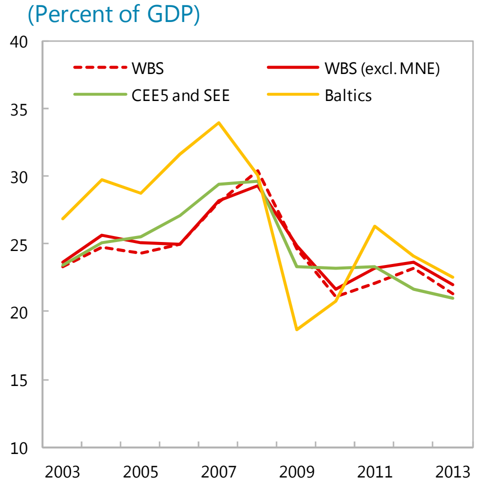


Source: IMF, World Economic Outlook.

Not only were current account deficits wider in the Western Balkans, their composition also differed from those of the New Member States. In particular, trade deficits were much larger than those in Central and Southeastern Europe. At the same time, steady surpluses in income and transfers balances, most notably remittances, partially mitigated current account deficits.[3,4]

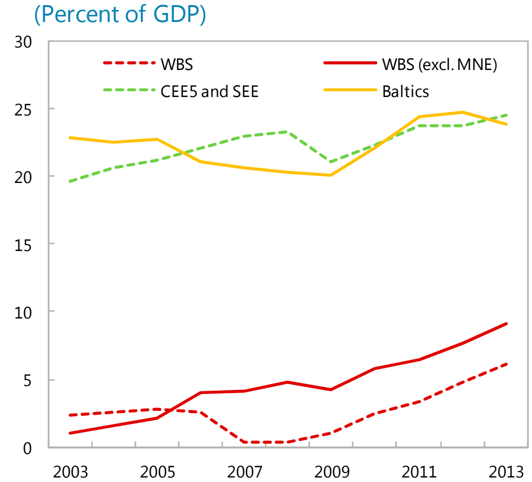
What were the drivers of current accounts over this period? Investment in the Western Balkans as a share of GDP was similar to that in Central and Southeastern Europe, but savings were substantially lower, and fell even further prior to the onset of the global crisis. The combined effect was substantially worse savings-investment balances. Although difficult to prove, it seems plausible that the relatively limited savings could be explained by lower incomes, more liquidity-constrained

Investment
(Percent of GDP)



Source: IMF, World Economic Outlook.

Domestic Savings
(Percent of GDP)



Source: IMF, World Economic Outlook.

[3] Pissarides, Sanfey, and Tashchilova (2006) note that households that receive remittances spend more, especially on items such as clothing and footwear and hygiene goods, which are less likely to be import-intensive.

[4] One reason that the CEE5 had a consistently negative income balance is because many of these countries are part of the German-Central European supply chain, so profit remittances are sizable.

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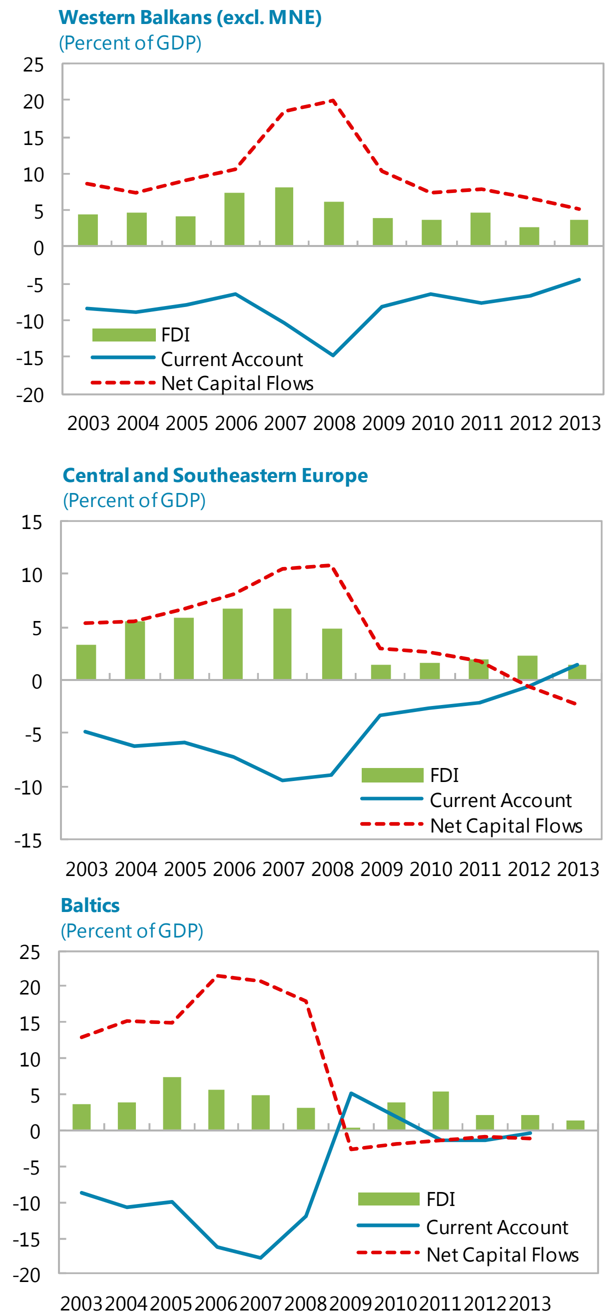
households, a larger share of informal economic activity, and a high degree of cash utilization in the Western Balkan economies (in line with the lower use of bank accounts by individuals—see Chapter 3). As a result, reported income was likely lower than actual income, reducing measured saving rates for a given level of consumption, and to a degree, errors and omissions in the balance of payments statistics. Income from high remittances may have also contributed to the underreporting of income and underestimation of savings rates.

The widening external imbalances of the Western Balkan countries were financed by increasing capital inflows, mainly FDI. But as studies suggest, the size of the capital inflows did not seem well correlated with capital scarcity (IMF 2010a).[5] In terms of composition of flows, foreign direct investment (FDI) dominated up until about 2006. However, during 2006–08 bank inflows gained importance as foreign bank networks became more prevalent in the Western Balkans (Chapter 3). This composition of inflows is consistent with patterns observed across Emerging Europe, which suggest that the share of FDI in capital inflows tends to be negatively correlated with the level of national income—that is, as economies mature and GDP growth rates slow, the share of FDI in overall inflows falls (IMF 2010a).

Foreign Direct Investment, Current Account, and New Capital Flows



Source: IMF, World Economic Outlook.
Note: Direct Investment, net (BPM5), capital account, net (BPM5), and current account, all as a percent of GDP.

[5] For example, some countries with low capital-labor ratios (such as Bulgaria) did receive large capital inflows, but some (such as Albania) did not. This could be caused by other factors, such as the perceived country risk.

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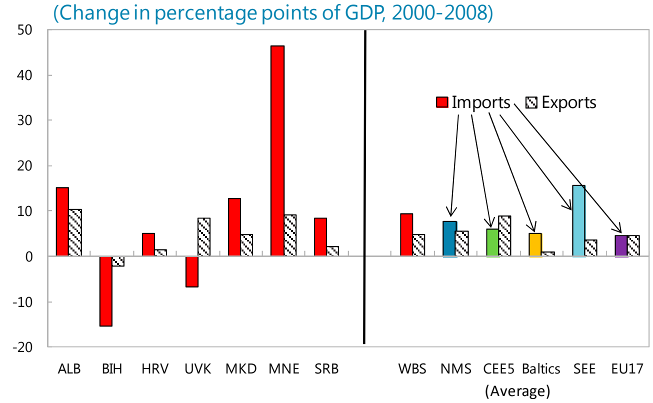
Capital Inflows and Growth

Not surprisingly, rising capital inflows allowed the Western Balkan economies to achieve much faster economic growth than before, though still lower than other Emerging European economies. In addition, unemployment remained elevated (Chapter 1, Section D). These observations raise questions about whether capital inflows were used as efficiently as they could have been.

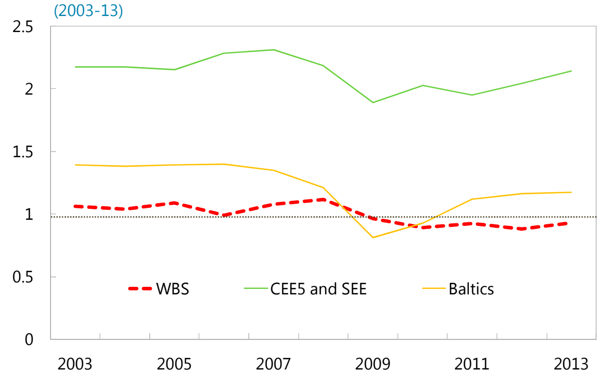
Imports and Exports
(Change in percentage points of GDP, 2000-2008)



Source: IMF, World Economic Outlook.
Note: 2003-2008 change for Montenegro.

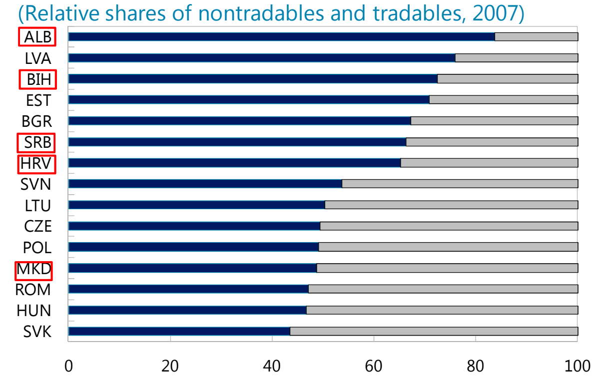
Capital inflows funded substantial increases in imports in the Western Balkans, which were only partly offset by growth in exports. In this respect, the Western Balkan economies followed the pattern of the Baltics. The fast growth in imports might have been appropriate, given the substantially lower capital stock in the Western Balkans than in the New Member States. But instead, much of the imports were absorbed as consumption rather than capital goods. Moreover, FDI inflows were directed into investment in nontradable sectors, such as financial services, real estate, and construction, rather than tradable sectors that can generate stronger export performance (Kinoshita 2011).[6]

Ratio of Capital to Consumption Imports by Region
(2003-13)



Sources: UNCTAD; and IMF staff estimates.

Foreign Direct Investment Flows by Sector
(Relative shares of nontradables and tradables, 2007)



Source: IMF, World Economic Outlook.

[6] Analysis in this paragraph should be treated with caution as this is based on UNCTAD data, which, due to coverage and methodology differences, are not fully consistent with balance of payments data from the IMF's World Economic Outlook database that underpin other analysis in this section.

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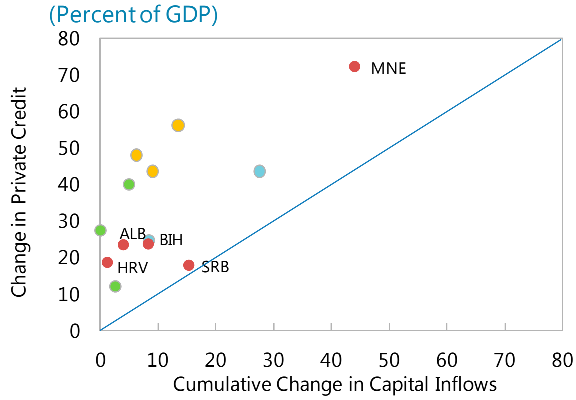
Capital Inflows and Domestic Prices

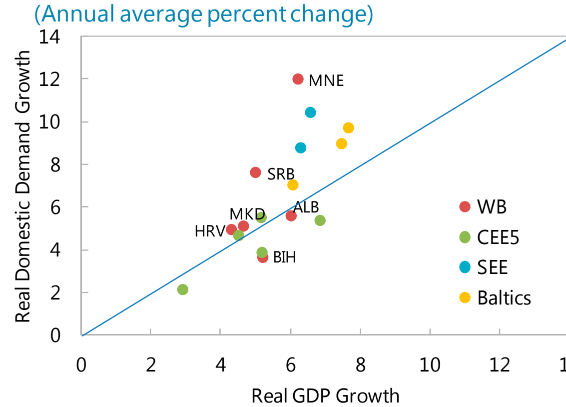
The substantial capital inflows affected the domestic economies of the Western Balkans in patterns similar to those observed in other emerging economies: growth in domestic credit (see also Chapter 3), as well as a sharp rise in domestic demand.

Capital Flows and Private Sector Credit, 2003-07
(Percent of GDP)



Sources: IMF, World Economic Outlook, IFS and IMF staff estimates.

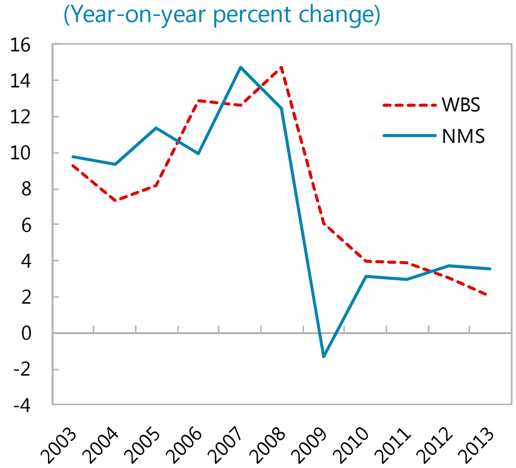
Domestic Demand and GDP Growth, 2003-08
(Annual average percent change)



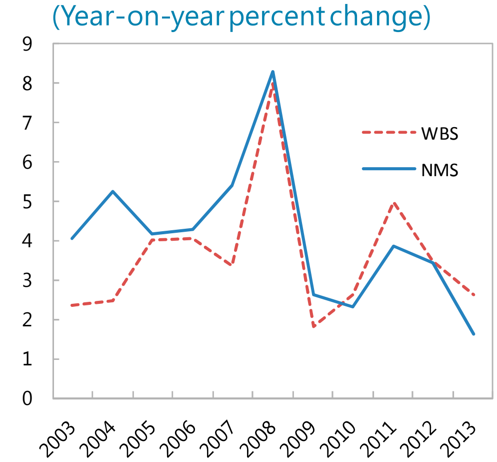
Source: IMF, World Economic Outlook.

Domestic booms were, in turn, accompanied by strong wage growth and rising price inflation. Qualitatively, the pattern of wage growth in the Western Balkans was very similar to that of the New Member States, despite much higher and persistent unemployment in the former. Because wage inflation exceeded price inflation, real incomes rose substantially—consistent with the consumption boom mentioned above.

Nominal Wage Growth
(Year-on-year percent change)



Inflation
(Year-on-year percent change)



Sources: IMF, World Economic Outlook; national authorities; and IMF staff calculations.

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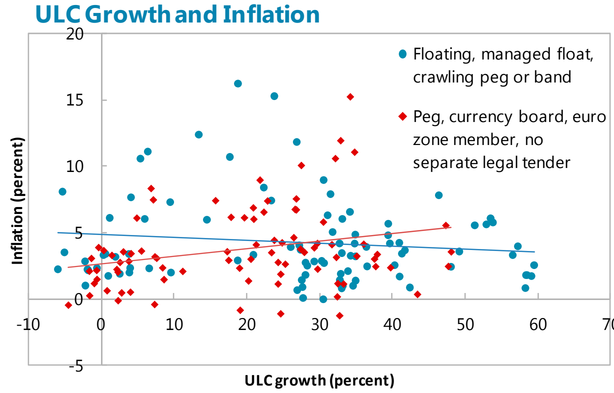
It is useful to consider why inflation did not pick up earlier and faster in the Western Balkans, given the substantial capital inflows and increases in domestic credit. One reason is that demand for goods was accommodated by imports, mitigating pressure on domestic supply, albeit with the consequence of widening current account deficits. Furthermore, as noted in other empirical literature, inflation has not generally been a leading indicator of asset price crises, particularly with respect to the crisis of 2007 (Kannan, Rabanal, and Scott 2011).

What was the role of the exchange rate regime in controlling inflation? Certainly, within the Western Balkan economies, it is notable that, for very similar increases in unit labor costs over the precrisis period, Serbia (which had a crawling peg during the period) had much higher inflation than Montenegro (which had unilaterally adoped the deutschmark in 1999). An external anchor thus appears to have provided monetary policy credibility to countries with a history of deficit monetization. At the same time, Albania, with its floating lek, also had low inflation by the standards of the region, suggesting that monetary policy credibility can be established without pegging the currency. More formally (as seen in the scatter plot), across Emerging European economies there appears to be no evidence of any clear difference in the responsiveness of inflation to cost pressures between those economies with fixed exchange rates (pegs, currency boards, or unilateral adoption of the euro) and those with some form of floating exchange rates.

ULC Growth and Inflation



Source: IMF, World Economic Outlook; national authorities; and IMF staff calculations.
Note: The sample contains Western Balkans economies and New Member States, 2003-13.

Macroeconomic Policy and Aggregate Demand

The choice of exchange rate regime was important nevertheless. Large capital inflows and the associated credit expansion made it difficult to control liquidity through monetary policy in all countries, but especially in those with fixed exchange rates. In circumstances of strong domestic demand, fiscal policy would ideally have offset domestic demand pressures and, indirectly, dampened credit demand. But rapid economic growth and the ensuing improvement in headline fiscal deficits gave the impression of an underlying strengthening of public finances, which, with the benefit of hindsight, turned out to be largely cyclical. Thus, as in most Emerging European economies, fiscal policy in the Western Balkans did not fully offset the domestic pressures associated with capital inflows. In fact, primary balances improved by less in the Western Balkans than in the New Member States.

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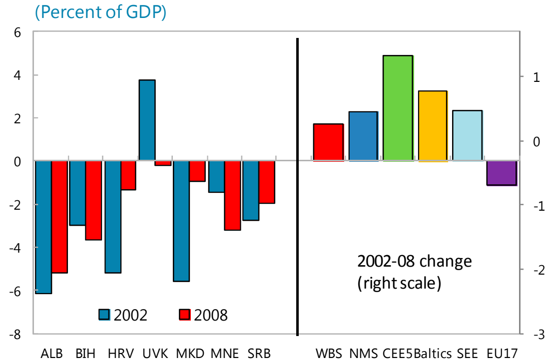
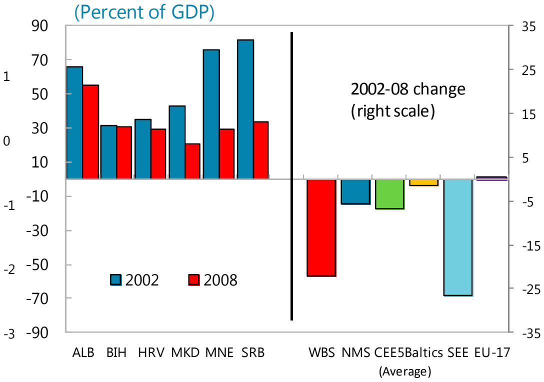
Primary Balance in 2002 and 2008
(Percent of GDP)



Source: World Economic Outlook.
Note: Debt data for Kosovo only available after 2009.

Gross Public Debt in 2002 and 2008
(Percent of GDP)



Across the region, fiscal revenues rose even as a share of GDP—and despite discretionary cuts in tax rates—due to a combination of reasons. Cyclical factors included strong economic growth, booming consumption, and one-off privatization receipts, and were particularly sizable in Montenegro and Kosovo. At the same time, previously very high government debt in the Western Balkans fell sharply to levels comparable to New Member States by 2008, in part driven by debt forgiveness through Paris club debt reductions, as well as improvements in primary balances and rapid GDP growth.

Paris Club Debt Reductions after 1990

Country	Date of treatment	Type of treatment
Albania	December 1993	Classic
Albania	July 1998	Naples 50%
Albania	January 2000	Classic
Bosnia and Herzegovina	October 1998	Naples
Bosnia and Herzegovina	July 2000	Naples
Croatia	March 1995	Classic
FYR Macedonia	July 1995	Classic
FYR Macedonia	September 2000	Ad hoc
Serbia and Montenegro	November 2001	Ad hoc

Source: Paris Club (www.clubdeparis.org).

Buoyant revenues and lower debt supported the appetite for higher public spending, especially in the run-up to elections, and particularly on public wages and pensions, and ambitious infrastructure projects. Econometric analysis confirms that fiscal policy in the Western Balkans has a high degree of inertia, and is less responsive to business cycles than in the New Member States or Advanced EU economies. In addition, the component of spending that is not explained by inertia or the business cycle is somewhat larger in the Western Balkans, which may be picking up the effect of electoral cycles (Annex 2.1).

As discussed below, this combination of largely cyclical increases in revenues and rapid rises in mandatory spending led to accumulation of underlying fiscal vulnerabilities that came to the fore from the onset of the crisis and presented significant policy challenges in the postcrisis period.

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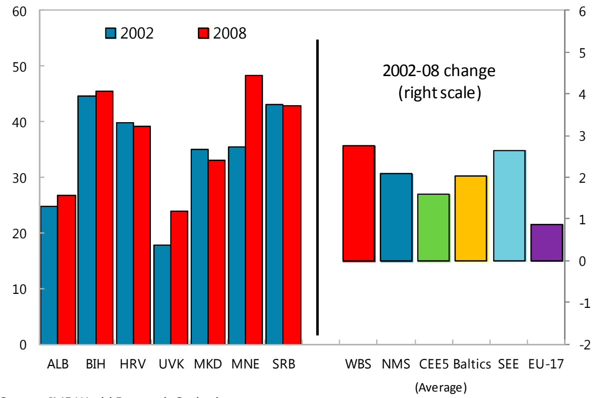
Revenue in 2002 and 2008

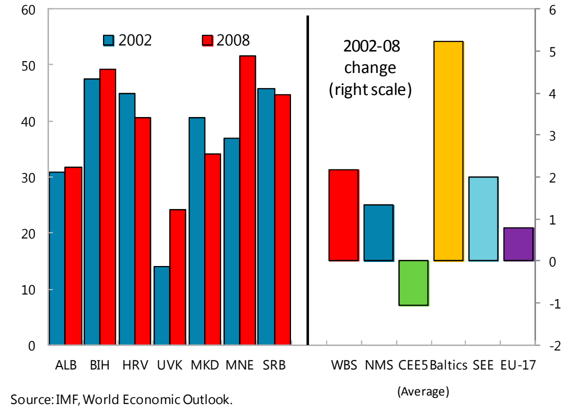
(Percent of GDP)



Source: IMF, World Economic Outlook.

Expenditure in 2002 and 2008

(Percent of GDP)



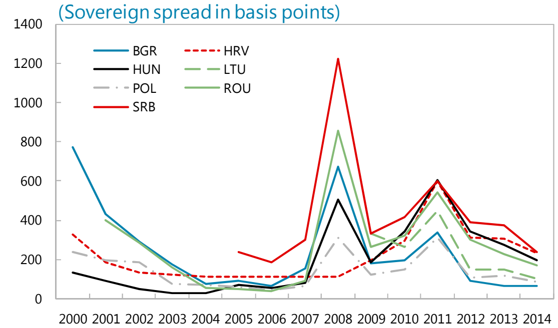
Source: IMF, World Economic Outlook.

C. Recession and Recovery after the Global Financial Crisis

The onset of the global crisis and consequent contraction of external financing forced adjustment in the Western Balkans, as in the rest of Emerging Europe. In the global financial turmoil that followed the demise of Lehman Brothers, global risk aversion increased sharply and inter-bank markets dried up. Sovereign risk premia spiked across the region. Growth rates across Advanced and Emerging Europe fell sharply. The Western Balkan economies experienced recessions that were *less* severe than those of the New Member States. However, the postcrisis recoveries in the Western Balkans have been weak, similar to those in Central and Southeastern Europe, and the Western Balkan countries need to grow at a faster pace than their richer peers in order to converge to average income levels of Advanced EU economies (see also Chapter 1).

EMBI Spreads

(Sovereign spread in basis points)

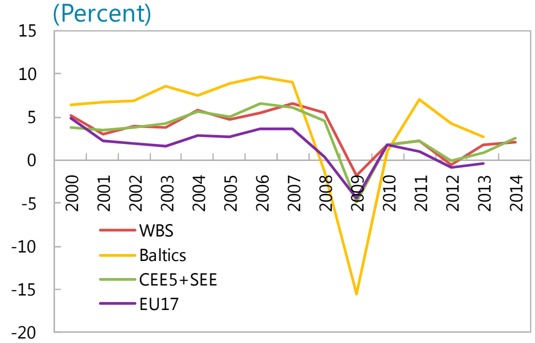


Source: Bloomberg.
Note: Global government spread for Croatia.

These observations raise a number of questions. Why were recessions less severe in the Western Balkans than in many New Member States at the peak of the crisis? And why has growth been lackluster since? We look at these questions first in terms of external and domestic factors separately, and then estimate their relative importance.

Real GDP Growth

(Percent)



Source: IMF, World Economic Outlook.

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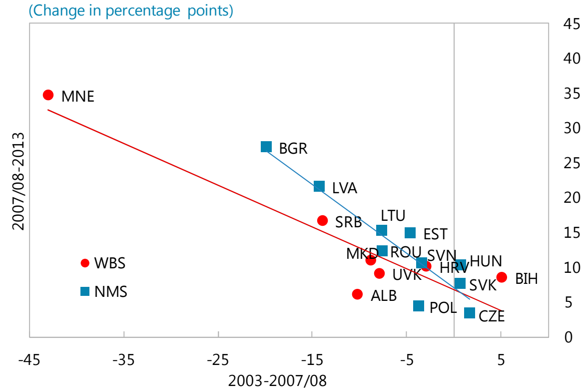
External Factors

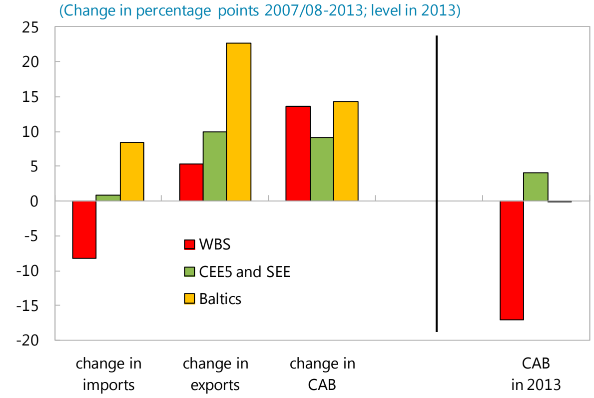
The onset of the global financial crisis triggered sizable current account adjustments across Emerging Europe, including in the Western Balkans. The reduction of the current account deficits of the Western Balkan countries was substantial and broadly similar to that in Central Europe, though smaller than in the Baltics. But the main difference was that the adjustment came predominantly through import compression in the Western Balkans, compared to the largely export-driven rebound in the New Member States. At the individual country level, the size of current account adjustment was highly correlated with the size of deterioration before the crisis.[7]

Current Account Balance
(Change in percentage points)



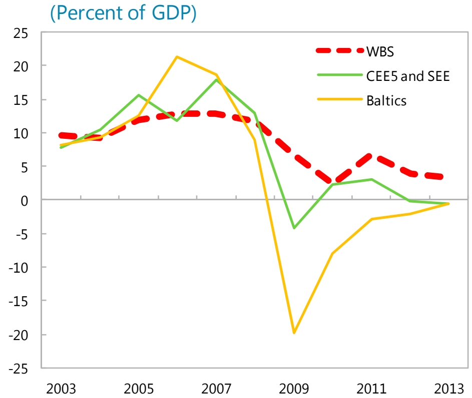
Sources: IMF, World Economic Outlook; and IMF staff calculations.
Note: 2007 for New Member States and 2008 for the Western Balkans, as determined by the peak of current account deficits.

Imports, Exports, and Current Account Balance
(Change in percentage points 2007/08-2013; level in 2013)



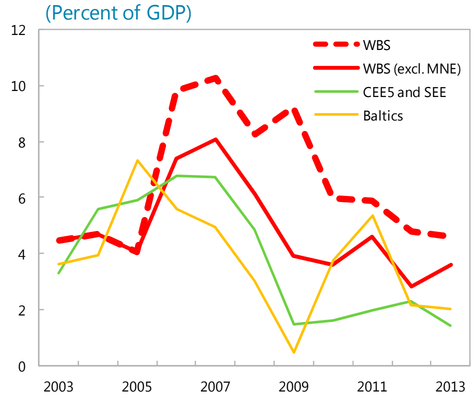
Sources: IMF, World Economic Outlook; and IMF staff calculations.
Note: 2007 for New Member States and 2008 for the Western Balkans, as determined by the peak of current account deficits.

Capital Inflows
(Percent of GDP)



Sources: IMF, World Economic Outlook; and IMF staff estimates.

Foreign Direct Invesment
(Percent of GDP)



Sources: IMF, World Economic Outlook; and IMF staff estimates.

[7] Current account adjustment is measured as the change in the current account between 2007/8 and 2013 (2008 for the Western Balkans and since 2007 for New Member States, as determined by the peak of current account deficits).

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What explains this lackluster trade performance in the Western Balkans? It seems plausible that it was related to two factors noted before: first, incomplete structural reforms, and second, capital that had been directed more at domestic consumption than investment. But importantly, the trade and current deficits remained relatively large in the Western Balkans during the postcrisis period, making these countries vulnerable to global volatility of capital flows.

Fortunately, capital flows appear to have been more stable in the Western Balkans than in many other Emerging European economies in the postcrisis period. FDI continued to flow in, albeit at a lower level, and portfolio and other inflows remained positive and substantial as well. This was in contrast with the experience of the New Member States, which saw declining and eventually negative capital inflows. Capital flows dropped particularly sharply in the Baltics and Romania, where a large share of inflows during the boom years had been channeled to the real estate sector, either directly through FDI or capital inflows into banks (Mitra 2011). The relative stability of flows to the Western Balkans may have reflected the relative prevalence of non-real estate FDI in the region (with the exception of Montenegro), and the relatively smaller share of inflows to banks. The relative illiquidity of assets may have mitigated foreign investors' ability to withdraw capital quickly.

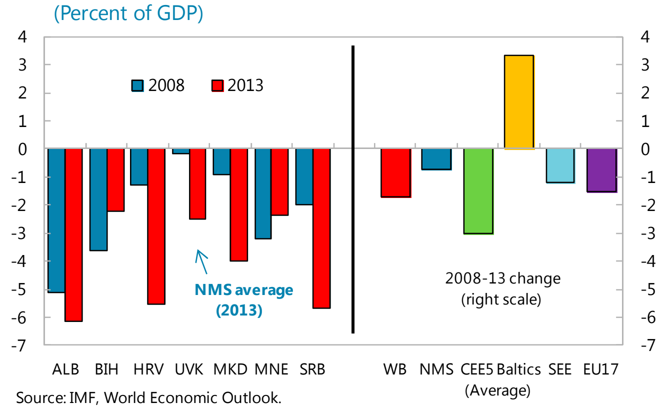
Domestic Policy

What role did domestic policies play since the onset of the crisis?

The Western Balkan economies lacked the fiscal space and the financing to accommodate falling revenues, and thus resorted to procyclical fiscal tightening. This took place in the form of restrained expenditures and/or increased tax rates, and exacerbated the adverse impact of the external shock on economic growth.

Overall Fiscal Balances in 2008 and 2013

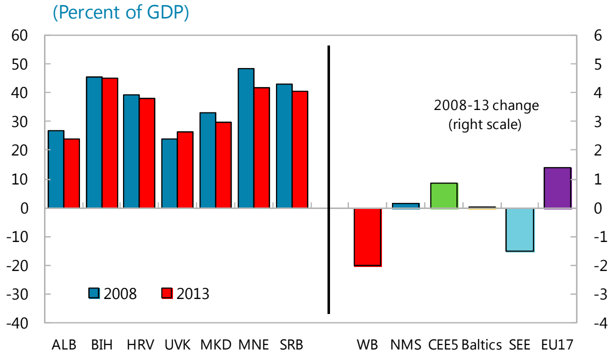
(Percent of GDP)



Source: IMF, World Economic Outlook.

Revenues in 2008 and 2013

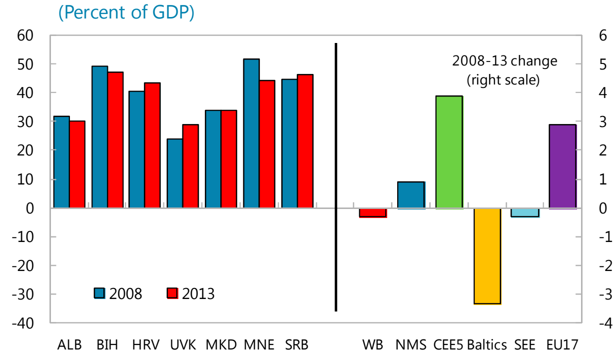
(Percent of GDP)



Source: IMF, World Economic Outlook.

Expenditures in 2008 and 2013

(Percent of GDP)



Source: IMF, World Economic Outlook.

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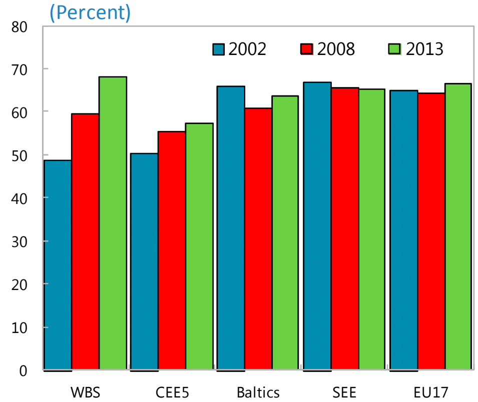
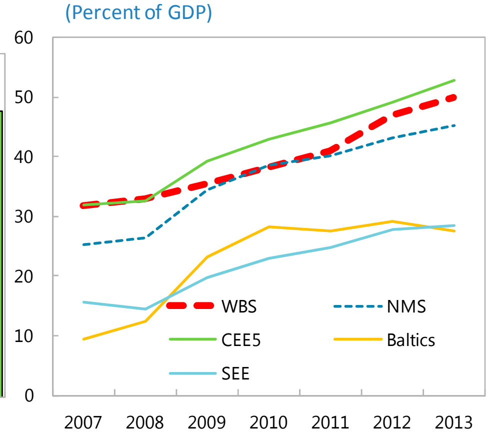
In contrast to most of the New Member States, the Western Balkans experienced a persistent fall in revenues—mostly in taxes on goods and services and international trade and transactions—throughout the recovery period. At the same time, these economies struggled to cut public spending. Mandatory expenditures—particularly public sector wage bills and pensions—increased rapidly before the crisis and proved difficult to scale back (Box 2.2). Instead, capital spending was often cut, undermining growth potential. Overall, fiscal deficits in the Western Balkans remained relatively high, and public debt escalated rapidly—another unfortunate legacy of the crisis.

Precommitted Spending as a Share of Total Expenditures
(Percent)



Source: IMF, World Economic Outlook.

General Government Gross Debt
(Percent of GDP)



Source: IMF, World Economic Outlook.

Most Western Balkan economies lacked independent monetary policy, and thus were unable to use it to support economic activity during the crisis. Countries that had unilaterally adopted other currencies, such as Kosovo and Montenegro, lacked the ability to provide liquidity altogether. But even in economies with flexible exchange rates and open capital accounts, such as Albania and Serbia, monetary policy was nonetheless constrained due to weak credibility and the need to avoid high exchange rate volatility (owing, for example, to unhedged foreign-currency denominated loans). In such circumstances, the burden of adjustment tends to fall on domestic prices. However, given widespread nominal wage rigidities, real exchange rates have not fallen by as much as in the New Member States. Consequently, as highlighted above, export growth has been weak and failed to drive the recovery in the Western Balkans.

External versus Domestic Factors

Which of the factors discussed above—external and domestic—were the most important in explaining economic developments after the global crisis?

The first issue is the ***size of the recession at the height of the crisis***. This is examined by using a cross-sectional regression of the size of the peak-to-trough decline in real GDP on explanatory factors designed to measure the degree of overheating and imbalances in the boom period (Annex Table 2.3.1 in Annex 2.3). The results suggest that real GDP fell by more in economies that had larger current account deficits and fixed exchange rates, consistent with those economies lacking relative

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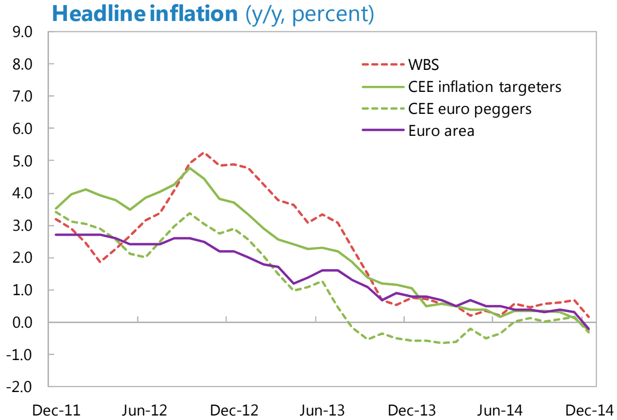
price buffers. There is a highly significant dummy variable that indicates that the Western Balkan economies experienced a smaller recession than the New Member States, consistent with observed growth patterns. This may be due to the still-positive net inflows to the Western Balkans at the peak of the crisis, which alleviated the need for a sharper economic adjustment as observed in the other Emerging European peers.

The second issue is the ***growth recovery in the aftermath of the crisis***. A cross-sectional regression of real GDP growth since the trough indicates a significant role for export expansion (Annex Table 2.2.2). As discussed above, the Western Balkans fared relatively poorly in this area due to lingering competitiveness problems and narrow export bases. In addition, the results suggest that having a fixed exchange rate regime is also associated with stronger growth from the trough, likely reflecting the export-driven rebounds in the more open and diversified Baltic economies.

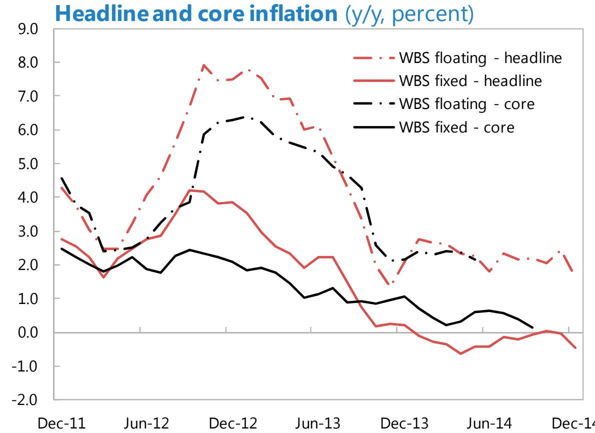
Going forward, recoveries in the Western Balkans face additional risks: first, from weak external demand (as discussed in Chapter 1) and, second, the threat of deflation spilling over from Advanced European economies. Together, these two forces would further weaken nominal demand. Given high levels of public debt and already-high levels of non-performing loans, an extended period of very low inflation or deflation would be damaging. Other Emerging European economies have already been facing downward price pressures. Western Balkan economies with fixed exchange rate regimes of some sort would likely be most affected; indeed, outright deflation in headline CPI has recently been seen in Bosnia and Herzegovina, Croatia, Kosovo, Macedonia, and Montenegro. Although this has mainly been because of food and fuel prices, core inflation has been falling steadily. And even in Albania and Serbia, with their floating exchange rate regimes, inflation is currently below target.

Headline inflation (y/y, percent)



Sources: Eurostat; and national authorities.
Note: CEE inflation targeters include the Czech Republic, Hungary, Poland and Romania; CEE euro peggers include Bulgaria, Latvia and Lithuania.

Headline and core inflation (y/y, percent)



Sources: National authorities; and staff calculations.
Note: Core inflation is non-food non-energy; with the exception of Bosnia and Herzegovina (non-food).

D. Lessons from the Crisis and Policy Challenges

Are the Western Balkan economies more stable than when they entered the new millennium? What lessons should be drawn from their precrisis and postcrisis experiences? And what are the implications for policies going forward?

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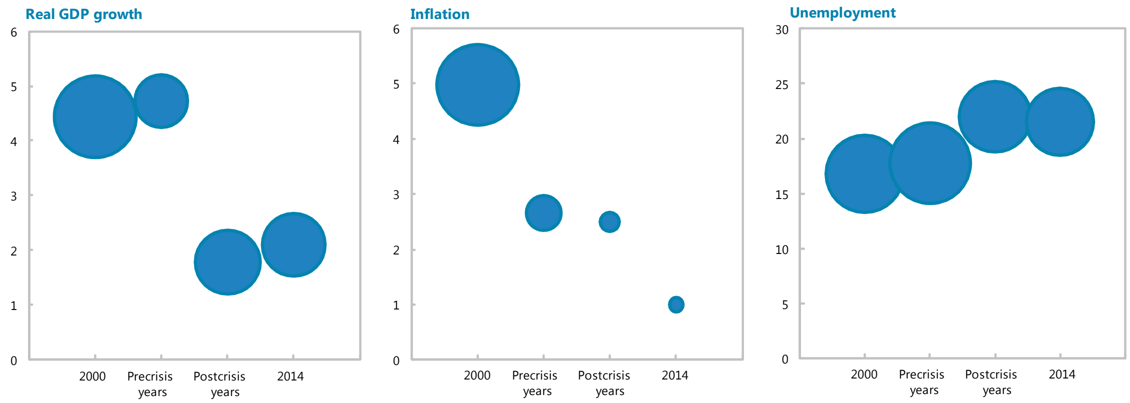
Compared with the 1990s, the Western Balkan economies are certainly more stable. GDP growth rates have become more uniform across the region over time. In particular, extreme inflation is a thing of the past, and is much less variable across countries. But from a welfare point of view, the picture is more mixed. Growth, while recovering across the region, is lower for most countries than in 2000. Regrettably, unemployment rates have risen further to very high levels.

Western Balkan Economies Before and After the Crisis and to Date

(Median, percent. Size of bubble is proportional to range across WBS economies—smaller bubbles indicate lower variance across the sample.)



Source: IMF, World Economic Outlook.

The recessions at the peak of the crisis were not as severe in the Western Balkans as in other Emerging European economies. To some extent, that reflects good luck: the credit booms driven by "hot" cross-border flows that caused much damage in other economies were generally late to arrive in the Western Balkan economies and were curtailed at an earlier stage. As noted above, capital flows, although diminished, held up surprisingly well after the crisis.

Two main legacies of the crisis are persistently weak growth and high unemployment. But underlying structural factors are also important. In particular, during the boom years the Western Balkan economies built economic foundations that were less conducive to a rebound from the crisis. This is because capital inflows were directed more at nontradable sectors and supported consumption, rather than at funding investment in tradable sectors.

What then are the lessons for policies in the Western Balkans?

The boom-bust experience of the Western Balkans since the turn of the millennium helps to highlight the implications of some form of fixed (or nearly-fixed) exchange rate. Western Balkan countries as a group showed a strong preference for fixed exchange rate regimes. In the early years of transition these regimes helped stabilize inflation and safeguard living standards, and thus presented an understandably attractive policy option. However, later on, countries with both fixed and more flexible rate regimes were equally successful in controlling inflation, and the costs of the policy choice to fix the exchange rate became more obvious, as countries with fixed exchange rates tended to experience bigger booms and larger imbalances (see also Chapter 3). Regardless of the exchange rate regime, the Western Balkan economies need to build up the flexibility of their real economies and buttress their ability to withstand shocks. This in turn places greater emphasis on fiscal and structural policies.

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Clearly, having more countercyclical fiscal policies would have benefited most economies during the boom, and given them room to adjust more easily after the crisis. That most Western Balkan economies did not do so is not unusual. In real time during the boom years, most countries found it difficult to distinguish between cyclical and structural increases in revenues, and as a result fiscal policies were not sufficiently countercyclical. And when faced with the fiscal financing constraints at the onset of the crisis, most of the Western Balkans were forced to resort to procyclical tightening in the absence of adequate fiscal space. In particular, given rigid expenditure patterns, they often cut capital spending, further undermining growth. In light of this, the policy priorities for the region going forward include reducing high public debt ratios, tackling high mandatory spending, and increasing the resilience of public finances to future economic shocks (see also Annex 2.3).

The experiences before and after the crisis also point to the need for more progress in structural reforms, as the reform process in most of the Western Balkans countries remains incomplete (see Chapter 1). From a macroeconomic point of view, structural reforms should aim to diversify economic activity and increase export shares, which in turn requires attracting investment into tradable sectors—an area where the Western Balkans lag. This would help reduce the high trade and current account deficits across the region. As the same time, widening the range of savings instruments would help increase the share of formal savings in the economy and intermediate them to productive projects that would raise the capacity of the economy to produce and grow (Chapter 3). Finally, structural reforms in labor and product markets would help increase the real flexibility of the economies and enhance their ability to absorb shocks.

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Box 2.1. The Western Balkans and the IMF

The International Monetary Fund has been a close partner of the Western Balkan States throughout the process of economic transformation. As early as the 1980s, the Fund provided financial and technical support for initial reform steps in Yugoslavia. Its activities in the region expanded substantially in the 1990s, following the collapse of communism and the breakup of Yugoslavia.[1] In those days, the Western Balkan countries faced significant challenges to transition toward a market economy, often needing to set up institutions and frameworks from scratch. More recently, the IMF has been assisting with challenges related to the adverse effects of the global financial crisis and the unfinished structural reform agenda. The Fund's support has come in the form of its three main activities—surveillance, program lending, and training and technical assistance.

IMF Surveillance has provided policy advice to facilitate the economic transformation. In the initial stages of the transition, the focus was on policy paths needed to achieve macroeconomic stabilization and structural reforms to support the transformation to market economies. The modalities of involvement were wide ranging, including staff visits, Article IV consultations (which generally take place annually for most IMF member countries), and regional conferences and cross-country analysis. In addition, in the aftermath of the global financial crisis, cross-country policy initiatives, such as the Vienna I and Vienna II Initiative (Chapter 3), provided coordination between private and public stakeholders by bringing together parent bank groups from Advanced EU economies, home and host country authorities, and multilateral organizations.

IMF program lending has supported countries' economic stabilization and transformation programs through lending conditioned on implementation of key policy reforms. Since 1992, the Western Balkan countries have benefited from 29 IMF arrangements for a cumulative total of SDR 8.2 billion.

- *Systemic Transformation Facility (STF*). A number of Western Balkan countries had their first economic programs supported by this IMF transitional facility set up after the fall of the Berlin Wall—for example, the former Yugoslavia in 1990, Albania in 1992, FYR Macedonia in 1994, and Croatia in 1995. These early arrangements were not large in size (ranging between 25 and 80 percent of the countries' quota at the IMF), as financing under the STF was strictly limited, reflecting the risks involved and the limited repayment capacity.
- *Emergency postconflict assistance* supported several of the Western Balkan countries that emerged from conflicts and faced the daunting task of rebuilding their economies without losing control over their financial policies. Examples include Bosnia and Herzegovina in 1995, the Former Republic of Yugoslavia in 2000, and Albania in 1997–98. As is generally the case, IMF assistance also catalyzed additional financial and technical support by the international community.
- *Stand-by Arrangement (SBA), Extended Fund Facility (EFF), and the Precautionary Credit Line.* Over time, programs in the Western Balkan countries have moved to more traditional IMF instruments, reflecting both the political stability in the region and progress in the transition process. In most cases, the overarching goal of these programs has been to ensure fiscal and financial stability in the wake of the global financial crisis, and to advance the unfinished structural reform agenda. Specific examples include FYR Macedonia, which concluded a Precautionary Credit Line in 2011, and an SBA in Kosovo in 2012. In addition, Bosnia and Herzegovina and Serbia currently have an SBA, while Albania has an EFF arrangement, both with significant access.

[1] The expansion of IMF membership took place through the 1990s, with Albania joining in 1991, FYR Macedonia, Bosnia and Herzegovina, Croatia and the Federal Republic of Yugoslavia (FRY) in 1992, Montenegro in 2007, and Kosovo in 2009.

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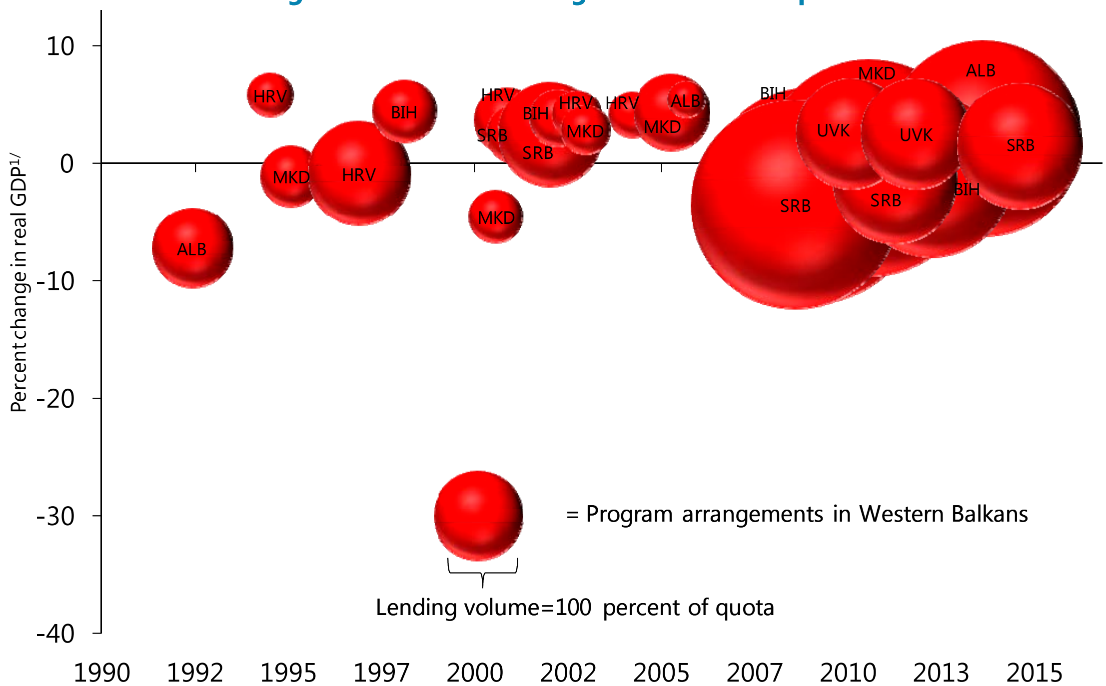
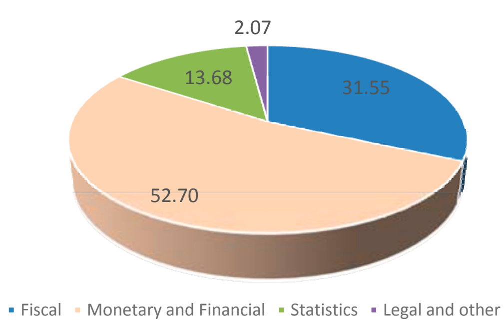
IMF Programs in WBS - Lending Volume and Output Declines

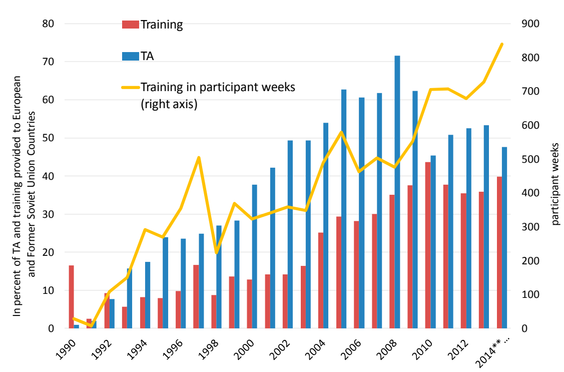


1/ Maximum cumulutive decline in three years from program inception (or lowest growth if no decline).

IMF technical assistance and training have played a critical role in advancing structural reforms, and have helped countries create and maintain effective institutions, laws, and frameworks, as well as formulate and implement sound policies that are conducive for stability and growth. Technical assistance and training have been particularly important in the newly independent states where institutions had to be built from scratch. Not surprisingly, considering the starting positions of the Western Balkans, the region has been a heavy recipient of IMF assistance. Since 1990 the IMF has provided some 196 person-years of technical assistance to the Western Balkans and some 5,900 participant weeks of training, much of it in the Joint Vienna Institute (JVI). Over this period, about 50 percent of technical assistance to the region has been directed to the monetary and financial areas, 30 percent to the fiscal area, almost 15 percent to statistics, and the rest to legal and other issues. Training, delivered mostly by JVI, has dealt with all aspects of formulating macroeconomic policies.

Technical Assistance and Training in the Western Balkan Countries





Source: Institute for Capacity Development (ICD), RAP data; ICD Participant and Applicant Tracking System (PATS); and Joint Vienna Institute (JVI) Participants Database. Note: Training refers to ICD courses delivered at the JVI.

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Recent IMF technical assistance and training to the region has had some tangible achievements:

- *Public finances*. Capacity-building has focused on putting in place or improving fiscal frameworks, budget planning and execution, revenue administration, and revenue and expenditure policies. There are many examples where IMF technical assistance has played a key role. For example, based on IMF assistance, Bosnia and Herzegovina adopted a budget law in late 2013 that covers all levels of government within the Federation. Since late 2013, the IMF helped Albania develop and implement a comprehensive strategy to prevent future arrears and clear current ones. It also advised Kosovo operationalize the fiscal rule in 2014.
- *Monetary policy*. In line with trends in emerging market countries elsewhere in the world, the IMF has closely assisted Western Balkan states transition and modernize their monetary policy frameworks. Notably, Albania, FYR Macedonia, and Serbia have been moving toward inflation targeting. IMF technical assistance in this area has focused on institutional and analytical factors, such as monetary policy instruments, developing local debt markets, enhancing transparency, and modeling.
- *Financial sector*. The aftermath of the global financial crisis has given rise to additional demands in the Western Balkan countries for IMF assistance in the areas of bank supervision and regulation, legal foundation and capacity-building for central banks, stress testing, developing government securities markets, and the resolution of problem banks. For example, with the help of IMF technical assistance, Kosovo recently revised its central bank law and introduced an emergency liquidity facility and a deposit insurance scheme. Separately, Serbia has recently revamped its bank resolution framework with guidance from the IMF.
- *Legal frameworks*. IMF technical assistance has supported the drafting of fiscal, tax, and central bank laws, laws on bank recapitalization, foreign exchange regulations, and debt restructuring plans, among others. The Joint Vienna Institute has hosted specialized training on domestic insolvency regimes, liquidation procedures, and options for out-of-court debt restructuring, with a special focus on small- and medium-sized enterprises.
- *Statistics*. Technical assistance and training have helped to address shortcomings in statistics related to national income accounts, balance of payments, and monetary and financial sectors. That Western Balkan countries follow internationally recognized standards for data dissemination today is a significant achievement. To strengthen real sector statistics, the IMF launched a technical assistance project in 2011 that has benefited most countries in the region. Looking ahead, guidance and assistance in collecting harmonized financial sector data will be a priority.

Going forward, the IMF expects to remain deeply engaged with the Western Balkan region. Whether through surveillance, IMF arrangements, or capacity development, the IMF stands ready to assist countries in raising their economic prospects.

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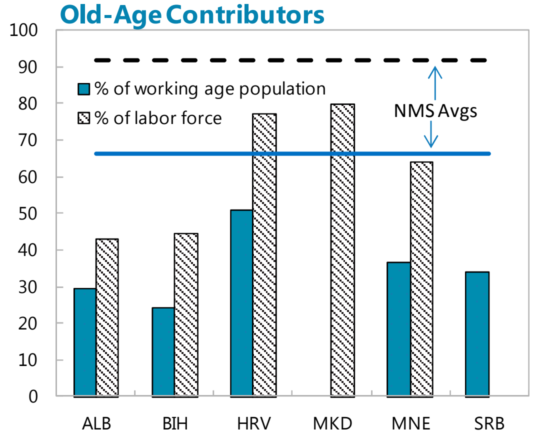
Box 2.2. Public Pension Spending in the Western Balkans[1]

Pension spending in most of the Western Balkans is much higher than in New Member States, amounting to almost 10 percent of GDP and almost a quarter of total government expenditure. The dominant system is a public pension scheme with compulsory contributions on a pay-as-you-go basis (the first pillar), which covers all workers in the formal economy. However, aging populations, low employment and participation rates, and a large informal economy threaten the sustainability of such systems. The widespread practice of early retirement that has accompanied privatization and enterprise restructurings has further worsened the situation.

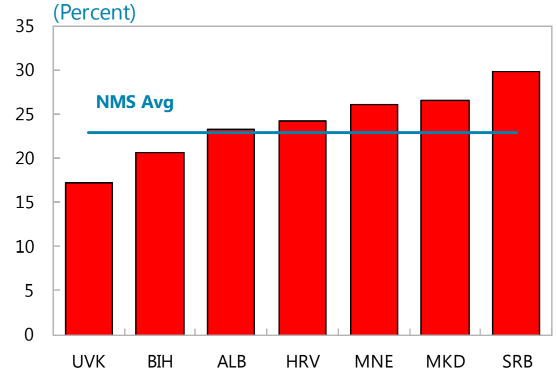
Old-Age Contributors



Source: International Labor Organization.
Note: 2009-11, depending on data availability.
NMS average excludes Romania due to lack of data.

Pension Spending as a Share of Total Government Expenditure, 2013

(Percent)

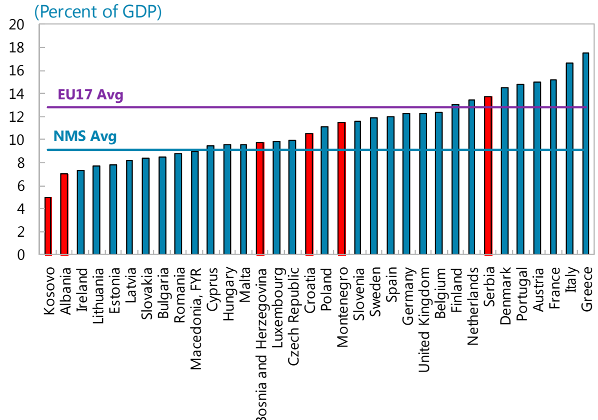


Source: National authorities.

As a consequence of financing constraints, pensions across the region are low in relation to subsistence needs. Going forward, the Western Balkan economies should concentrate on increasing participation and employment rates, reducing informality, and supporting the development of second and third pillars to ensure long-term fiscal sustainability.

Public Pension Spending

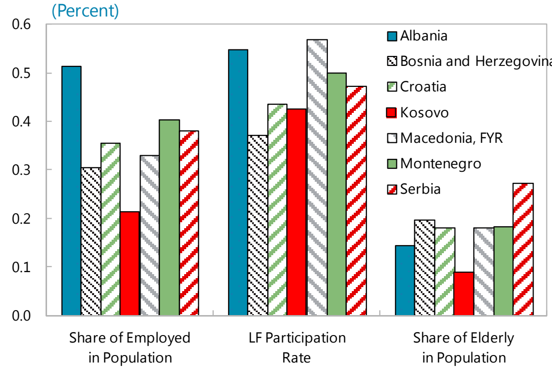
(Percent of GDP)



Source: Eurostat ; and national authorities.
Note: Data refer to 2012/2013.

Demographic and Labor Market Indicators

(Percent)



Sources: World Bank, The Atlas of Social Protection: Indicators of Resilience and Equity; and national authorities.
Note: Using latest available data (2004-2011). The economic support ratio is defined as the ratio of contributors to pensioners.

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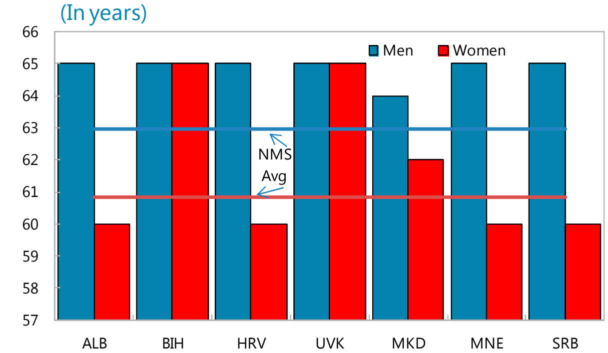
Several countries have introduced pension system reforms, albeit with wide variation in their scope:

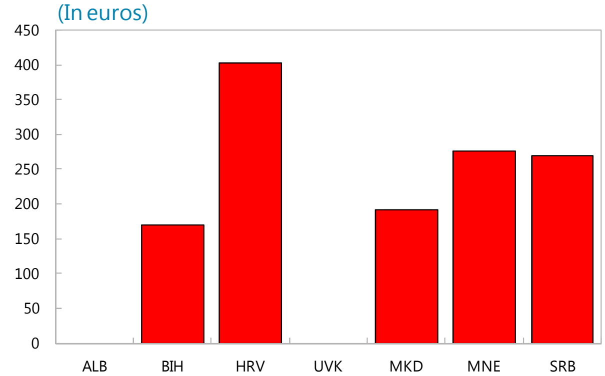
- Croatia and FYR Macedonia partly transformed the inherited redistributive universal pension systems into selective contributive systems, where the second pillar now replaces part of the first pillar social security pension. Third-pillar voluntary private pensions operate in Croatia, FYR Macedonia, Montenegro, and Serbia, but play only a small role.
- Serbia and Montenegro have instead focused on reforms to the existing pay-as-you-go system, changing indexation formulas, gradually increasing retirement ages and/or tightening eligibility criteria for early retirement, and reducing occupational and gender privileges. However, these reforms are unlikely to bring significant savings in the short run and the pension systems are still not sustainable.
- In Bosnia and Herzegovina, early reforms focused on harmonization between the two entities, and implementation of a new privileged pension law in the Federation is ongoing, focusing on reducing benefits, increasing the number of contributors, and raising the effective retirement age.
- Younger populations in Albania and Kosovo explain the relatively lighter pension burdens in these countries, though low employment rates and high levels of informality in these countries will contribute to increasing pressures as populations age. A combined first- and second-pillar system was created in Kosovo in 2002. In Albania contribution rate cuts, recent unfunded increases in benefits, and incentives for underreporting income led to an increase in the social insurance system deficit.

Statutory Retirement Age, 2013
(In years)



Sources: National authorities.
Note: Does not show planned increases not yet fully in effect.

Average Monthly Old-Age Pension, 2013
(In euros)



Source: National authorities.
Note: Does not show planned increases not yet fully in effect.

[1] See also Bartlett and Xhumari (2007); and ITUC-PERC (2012).

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