ICEG EUROPEAN CENTER

FINANCIAL SYSTEM AND MONETARY POLICY CHALLENGES IN THE SOUTHEAST EUROPEAN COUNTRIES

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EDITORIAL

After transition the Southeast European (SEE) countries followed a different transition path in comparison with the Central and Eastern European (CEE) economies. The delayed stabilisation, liberalisation and privatisation, the unfavourable political and economic climate resulted in a second recession period in the second half of the 1990s. Besides, the main engines of growth and the structure of the economy have become different as well. However, rapid growth returned in the new millennium and convergence to Western Europe has restarted.

The current development of the Southeast European countries induced some challenges and risks which merit attention. On the one hand, one can observe high growth rates in these economies based on private consumption and investments, while external imbalances cause problems and raise the question of sustainability of that growth. These two aforementioned factors are the two sides of the coin in the Southeast European countries.

There are other challenges in the SEE countries as well. In connection with the strong contribution to growth of domestic demand, the rapid development of credit in these countries should also be mentioned. The credit per GDP indicator in these countries increased significantly, though from a really low level. Obviously, there are similarities with the CEE countries where the same process was observable, namely credit increased extensively based on the rapid growth of loans to households. Accordingly, the CEE countries are good references in that respect.

Besides, it is also worth mentioning that labour markets in these countries also have to face with serious problems. Unemployment in several Western Balkan countries exceeds 20%, while employment rates are low. Since private sector's share in employment is still low, it was not able to create enough jobs to those who were laid off from narrowing public sector. Besides, the high role of informal sector and emigration of higher qualified workers are problems as well.

These are only some challenges that make the bright picture of current rapid growth and catching-up a bit shabby. However, it is important to observe and analyse these problems. ICEG European Center has a focus on the Southeast European region, we prepare regular analyses and forecasts on this region and organise conferences on issues related to the SEE countries.

In 2006 ICEG European Center organised a conference on European competitiveness and Lisbon strategy. This conference had sessions which discussed the most recent challenges of the Southeast European countries. Accordingly, the aim of this eBook is to review the key presentations of the aforementioned conference.

Although, the risks and challenges of the region is diverse, we tried to focus on one topic in this eBook. Finally, we have given a focus on financial and monetary focus in this publication and all papers are basically related to this topic.

The first paper is the 'underlying' paper which summarises the main processes and challenges the region has to face. Vladimir Gligorov, the author of this paper describes the main characteristics of economic growth, which was based on domestic factors, while price stability remained in most countries. The author enlightens the problem of external imbalances and raises the question of bubble fears in these economies. Besides, another key part of the paper is the issue of political risks. The future status of Kosovo is still not decided and it may cause instability. Besides, the outlook of the region is positive and further progress in EU integration is expected in the future.

The second paper focuses on financial sector, and basically on financial stability, efficient allocation and SME financing. Max Watson enlightens the rapid credit growth in the SEE countries and compares this development with that in the Central and Eastern European countries. According to the author, much depends on the policy and institutional settings which influence the development of the financial sector. Therefore, one of the key messages to the decision makers of the paper is that a healthy financial sector growth will depend on success across a range of policy areas.

Nevena Kulic, Nick Maddock and Ben Slay give a macroeconomic overview on the Southeast European countries but primary focus has been given to the Western Balkan countries in their paper. According to the authors, current economic development, which started later than in the case of CEE countries, can help improving the human development indicators in the Western Balkans as well. The start of recent economic growth was supported by favourable regional and global trends, the commitment to EU integration and rising economic stability, although the authors emphasise the challenges regarding external imbalances and labour market which comes hand in hand with sound economic growth. However, the authors conclude that SEE region has advantages in comparison with the CIS countries due to prospective EU integration which is a significant anchor to these economies. Besides, the question remains if rapid economic growth will solve the problems of high unemployment and poverty.

Dubravko Mihaljek also enlightens the significance of high credit growth in the Southeast European countries. According to the author, financial systems in these economies on the whole seem stable and sound. Sources of vulnerability in the corporate and household sectors are in most cases country-specific and no generalisations could easily be made. Nonetheless, if corporations, households and banks are forced to restructure their balance sheets after a rapid build-up of debt, one should not underestimate the risk of a prolonged period of slow growth in the affected countries.

The last publication analyses the euro adoption strategies of the two newly acceded Southeast European countries. Péter Bilek enlightens that the two countries adopted different euro introduction strategies. The advantages of the euro adoption are obvious and Bulgaria seems to follow the 'Baltic' strategy to introduce euro as soon as possible. On the other hand, Romania learned the lessons of the experiences of the countries joined the EU in 2004 and applied a later target date for joining the euro zone. According to the author, the inflation criteria will be the hardest to fulfil and adoption of euro is expected in around 2011 and 2014 in Bulgaria and Romania, respectively.

We hope you will enjoy reading this eBook!

VLADIMIR GLIGOROV*: STRONG GROWTH DESPITE POLITICAL UNCERTAINTIES

INTRODUCTION

Growth has remained strong in the Western Balkans and Turkey. Consumption is the main driving force, although investments have been a contributory factor. It is difficult to assess the contribution of net exports due to insufficient data and because both exports and imports have been growing. Foreign direct investment has also increased throughout the region, mostly linked to privatization, although increasing amounts of funds are being invested in green-field projects. Price stability still poses no serious problems, despite the volatile prices of imported oil and gas. Fiscal balances have been improving, although some doubts persist about the sustainability of those improvements in certain instances. Monetary policy remains an issue throughout the region, both in countries with fixed exchange rates and in countries with flexible exchange rates. Trade liberalization is moving ahead; however, more as a good intention than in reality. The regional free-trade area, CEFTA, will only come into being once the agreement signed last December has been finally ratified (estimated completion date mid-2007). Similarly, the process of EU association and accession moves on, albeit rather slowly.

The political shocks incurred by the independence of Montenegro and the subsequent parliamentary elections, as well as events in Bosnia and Herzegovina, have borne few economic consequences. The outcome of the elections in Serbia on 21 January 2007 was somewhat more problematic, coming as they did amid a political crisis that may well deepen with the imminent resolution of the Kosovo issue. In Kosovo itself, the situation is potentially unstable as impatience builds up in anticipation of the looming announcement of the province's independence. To date, the persistent political uncertainty and growing political risks have failed to dent the growth and development of the economies in the region. Nonetheless, the risks are still there, as are the risks of macroeconomic mismanagement. In the case of Turkey, global ructions will also have to be taken into account, although the country would seem to have weathered the shock of mid-2006 reasonably well.

The prospects for the region as a whole continue to be positive, despite the political and policy risks. In the absence of any major political instability being brought about by the change in the status of Kosovo, economic developments should continue to improve and relatively high growth rates should be sustained over the medium term. EU integration prospects should thus continue to improve for the Western Balkans, though not necessarily so for Turkey. In summary, the region's short-term prospects hinge on the remaining political risks being resolved, especially those emanating from the emergence of an independent Kosovo. Risks also persist with respect to short-term policy challenges, especially those governed by shifts in monetary policy. In the medium term, however, the region is still set to continue to recover and develop, all the more so as various reforms processes will pick up speed as relations with the EU improve. The EU will also bring additional financial resources, in the form of public transfers and private investments.

ROBUST GDP AND PRODUCTIVITY

Growth has been relatively strong and sustained in the Balkans since 2000: the turnaround year for the region as whole (see Table 1), which is about five years after the NMS. Growth has in fact accelerated in more recent years. Some of the regional laggards have improved their performance, whereas other countries have displayed certain weaknesses. It is important that: (a) Serbia continues to post high growth rates; (b) Croatia performs better than perhaps expected; and (c) Bosnia and Herzegovina (B&H) continues to enjoy high growth rates, despite the country's persistent institutional and constitutional problems. In addition, Montenegro has improved its economic performance after declaring independence, while Macedonia, traditionally a problem country

* K. Laski, M. Landesmann, P. Havlik and wiiw staff provided comments. Statisticians and editors are to be thanked coping with hard-to-find data and with a busy author.

when it comes to growth, has registered a growth rate close to 4% for the third year running. Only growth in Albania has continued to slow down due to persistent problems with energy shortages.

Table 1. Gross domestic product real change in % against preceding year

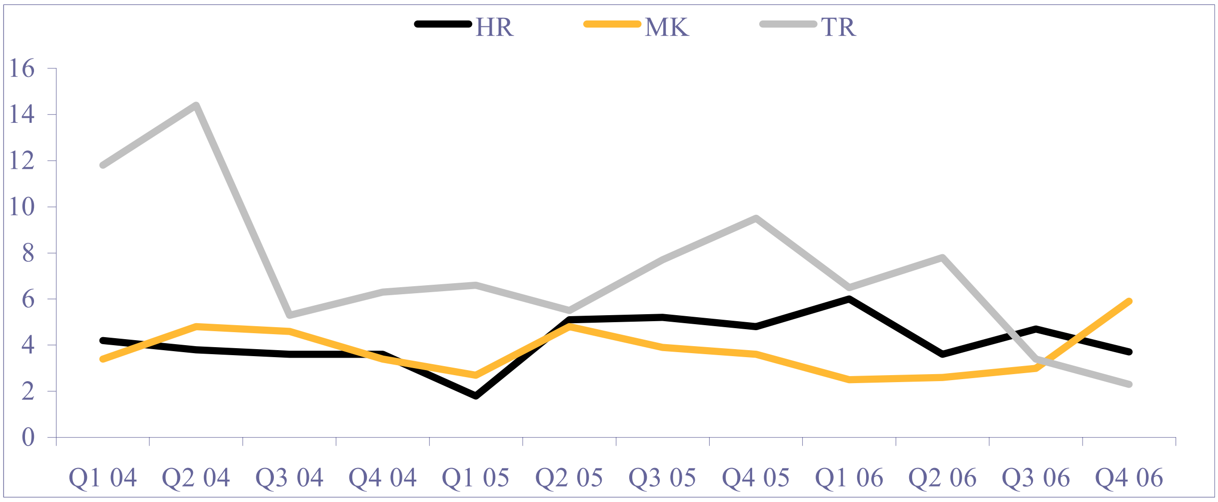
	1995	2000	2001	2002	2003	2004	2005	2006 [1]	2007	2008	Index 1990=100 2006	Index 2000=100 2006
									Forecast			
Croatia	6.8	2.9	4.4	5.6	5.3	3.8	4.3	4.5	4.4	4.4	112.5	131.3
Macedonia	-1.1	4.5	-4.5	0.9	2.8	4.1	3.8	3.5	4	4	101.0	110.8
Turkey	7.2	7.4	-7.5	7.9	5.8	8.9	7.4	5.0	5.5	6.5	184.2	129.7
Candidate countries	*7.0*	*6.9*	*-6.5*	*7.5*	*5.7*	*8.3*	*7.0*	*4.9*	*5.4*	*6.3*	*172.5*	*129.2*
Albania	8.9	6.5	7.1	4.3	5.8	6.2	5.6	4.8	5	5.5	154.3	138.9
Bosnia and Herzegovina	50.0	5.5	4.5	5.5	3.0	6.0	5.5	5.3	5.7	5.5	.	133.7
Montenegro	.	.	-0.2	1.7	2.4	4.2	4.3	4.5	5	5	.	118.0
Serbia	.	4.5	4.8	4.2	2.5	8.4	6.2	5.8	5	5	.	136.5
Potential candidate countries	.	.	*4.9*	*4.5*	*3.1*	*7.3*	*5.8*	*5.5*	*5.2*	*5.2*	.	*135.3*

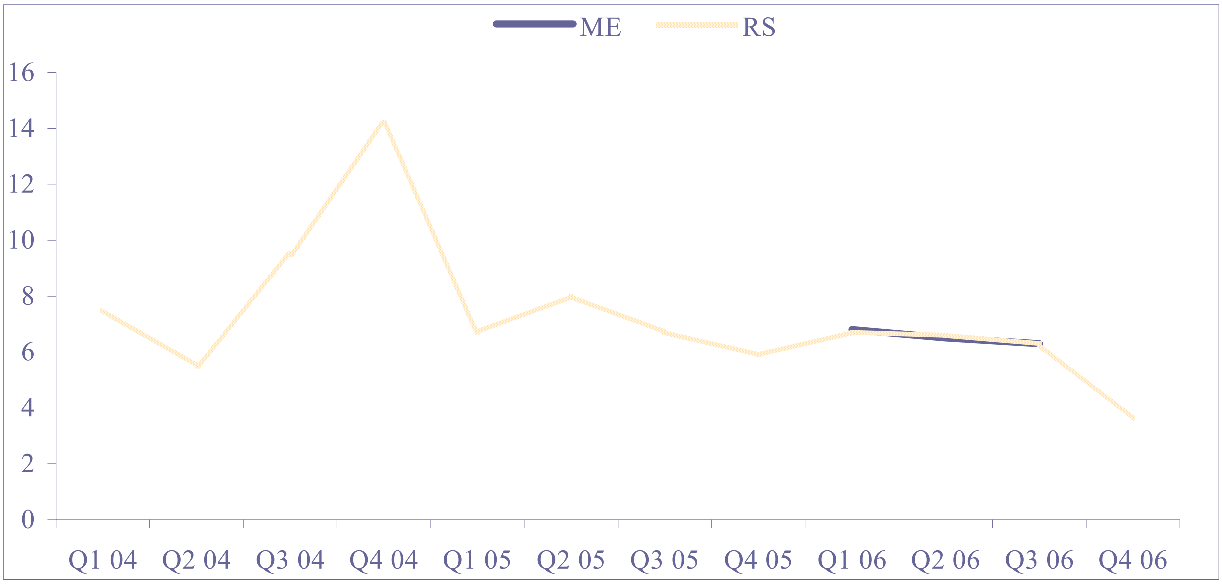
Notes: 1) Preliminary. Source: wiiw Database incorporating national statistics, forecast: wiiw

Growth in most countries is driven by domestic demand; this could raise some issues. Those concerns, however, do not seem to be fully warranted. In some cases, it has led to both fiscal and monetary policy instruments being used to achieve a certain tightening of domestic demand. As a result, in some countries quarterly growth rates have shown a certain measure of slowdown, as can be seen in Figure 1.

In most cases, this tightening does not seem to be altogether justified, at least not on the usual grounds that inflation would otherwise accelerate. Not only is the rate of inflation rather low throughout most of the region, but productivity has also been increasing rather impressively. Since 2000, practically all the growth in the region has been driven by gains in productivity. That has led to improved competitiveness as well as price stability. Indeed, the picture that emerges from Figure 2 is one of rather strong deflationary pressures at play in most countries' economies. Similar to trends observed previously in other transition economies, growth is based on the more efficient use of labour: more precisely it tends to save labour. Consequently, pressure to increase wages should not be expected; hence, price stability should not be a matter of great concern. As the second panel of Figure 2 shows, the potential candidate countries are still shedding labour. In principle, of course, the causes of inflationary pressures could lie elsewhere; some of them are discussed below. In general, however, inflation should not be difficult to keep under control, as a relatively strong downward pressure on wages exists owing to an excess supply of labour.

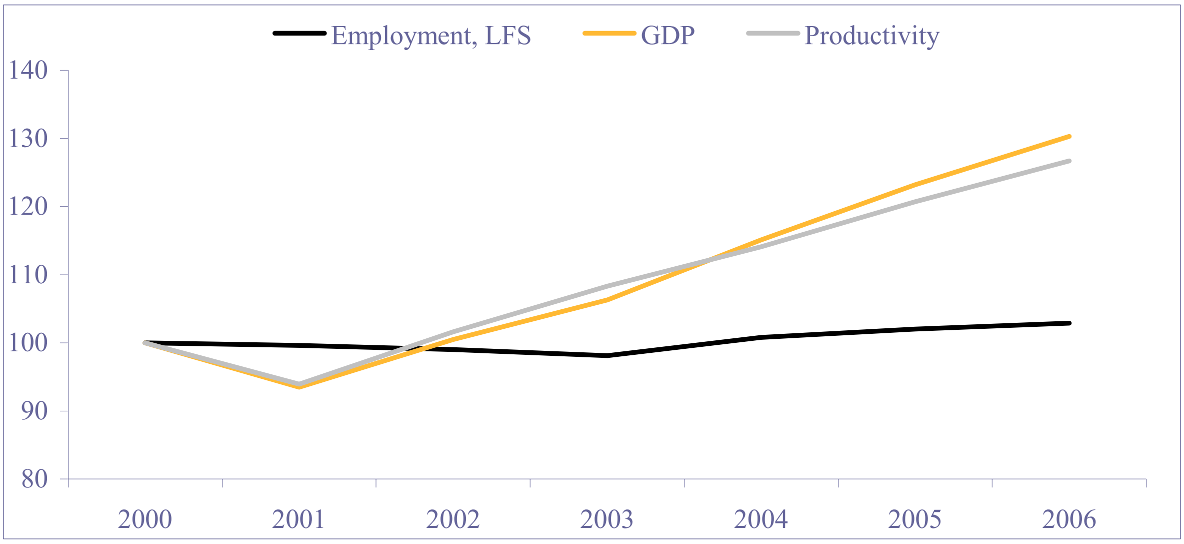
Figure 1. Quarterly GDP, 2004-2006
real change in % against preceding year



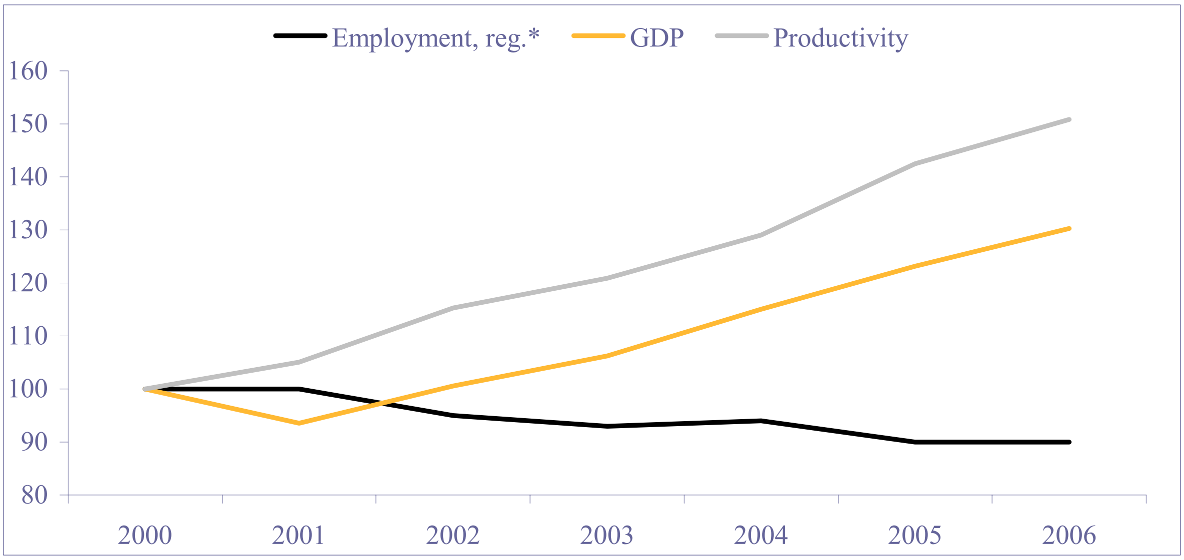


Note: HR (Croatia), MK (Macedonia), TR (Turkey) are candidate countries; AL (Albania), BA (Bosnia and Herzegovina), ME (Montenegro), RS (Serbia) are potential candidate countries.
Source: wiiw Monthly Database incorporating national statistics.

Figure 2. GDP, employment, productivity 2000-2006
2000 = 100
Candidate countries (HR, MK, TR)



Potential candidate countries (AL, BA, ME, RS)



** Serbia data are based on LFS.*

Source: wiiw Monthly Database incorporating national statistics.

In addition to consumption, investments have also grown, such as in Croatia, even though in most other cases the share of investment in the GDP is still relatively low. In Serbia, some uncertainty prevails about the investment figures; however, the share would still seem to be below 18% of GDP. In Bosnia and Herzegovina the figure seems to be around 20%, although here again there is some uncertainty about the data. In most cases, however, to the extent that the figures are available, data would indicate that the rate of investment is indeed growing. In some cases, as in both Montenegro and Serbia, public investments are also on the increase, and should be increased in Albania, while in most other countries private investments have also shown a noticeable increase. An indirect indication of improved investment climate is the growth of the private sector in Serbia, which has been fairly pronounced over the past couple of years. Also, the strong growth of construction throughout the region indicates a strong increase in private investments.

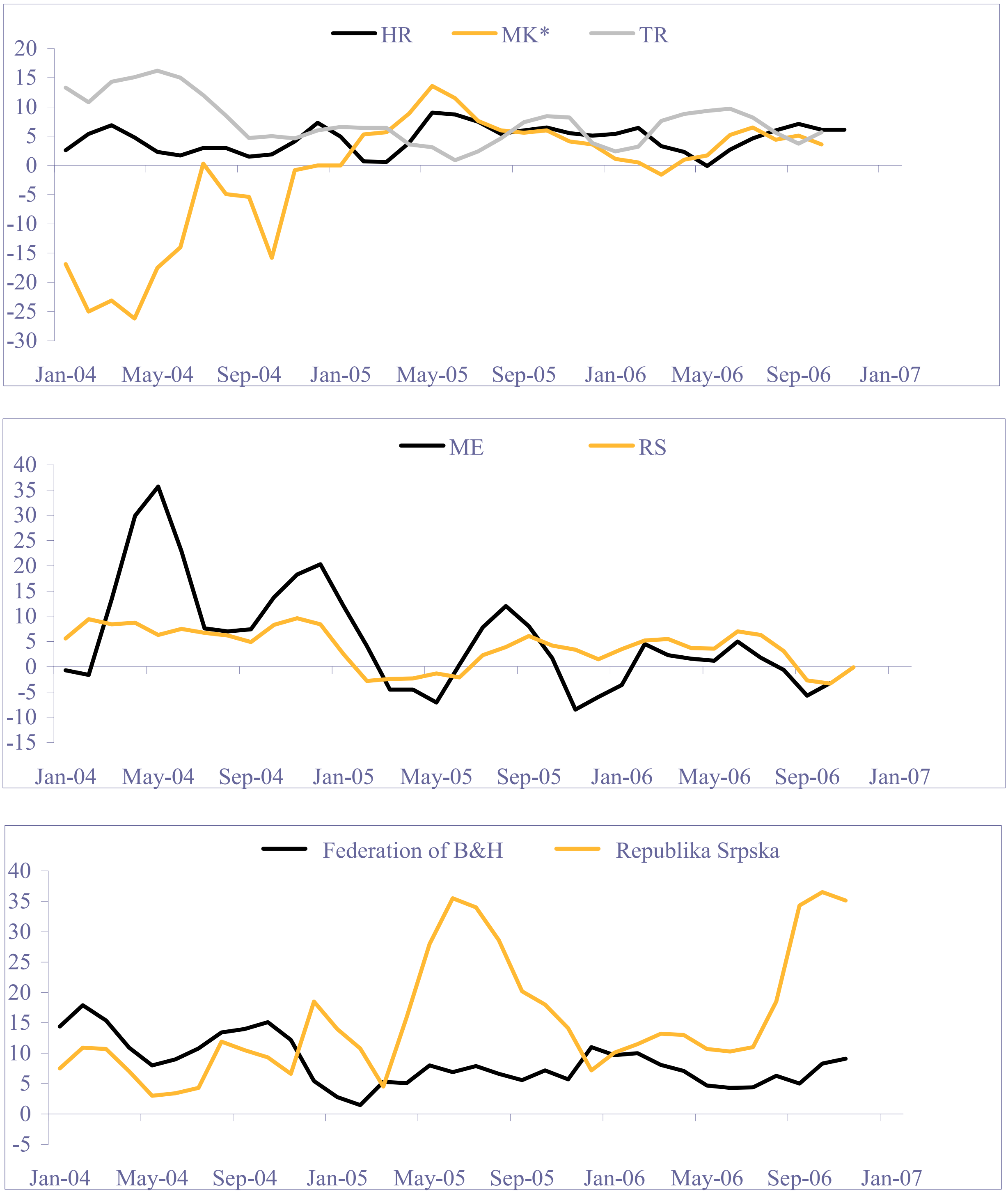
Table 2. Gross industrial production real change in % against preceding year

	1995	2000	2001	2002	2003	2004	2005	2006 [1]	2007	2008	Index 1990=100 2006	Index 2000=100 2006
									Forecast			
Croatia [2]	0.3	1.7	6.0	5.4	4.1	3.7	5.1	4.5	4.4	4.5	85.0	132.5
Macedonia [3]	-10.7	3.0	-2.9	-4.8	4.1	-2.2	7.0	3.4	5	5	55.0	104.1
Turkey	12.1	6.1	-8.7	9.5	8.7	9.8	5.5	6.3	6	9	205.1	133.8
Albania [4]	6.0	1.3	6.1	-5.1	29.0	14.1	1.3	1.5	2	3	54.5	152.4
Bosnia and Herzegovina [5]	.	7.9	4.9	5.7	5.1	12.1	10.8	11.5	11	11	.	161.4
Montenegro	.	4.2	-0.7	0.6	2.4	13.8	-1.9	1.0	3	3	.	115.4
Serbia	.	11.4	0.1	1.8	-3.0	7.1	0.8	4.7	5	5	.	111.7

Notes: 1) Preliminary. - 2) Enterprises with more than 20 employees. - 3) Excluding small enterprises. - 4) According to gross value added. - 5) wiiw estimates based on weighted averages for the two entities (Federation BH and Republika Srpska).
Source: wiiw Database incorporating national statistics, forecast: wiiw.

Overall good growth performance still does not feature all that prominently in industrial production growth. As can be seen in Table 2 and Figure 3, industrial production is growing at around 5% in the candidate countries, yet in effect it is still stagnating in both Serbia and Montenegro. Somewhat divergent trends can be observed in the two entities in Bosnia and Herzegovina; industrial production is recovering quite strongly in Republika Srpska, yet somewhat less convincingly in the Federation.

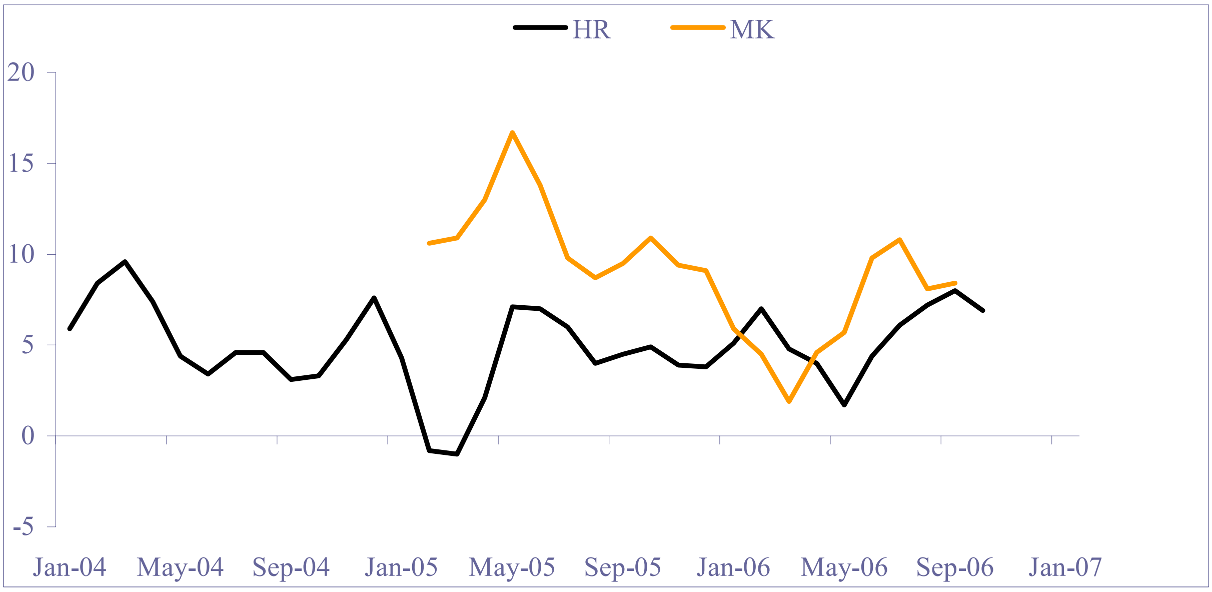
Figure 3. Gross industrial production in Southeast Europe, 2004-2006
year-on-year growth in %, 3-month moving average

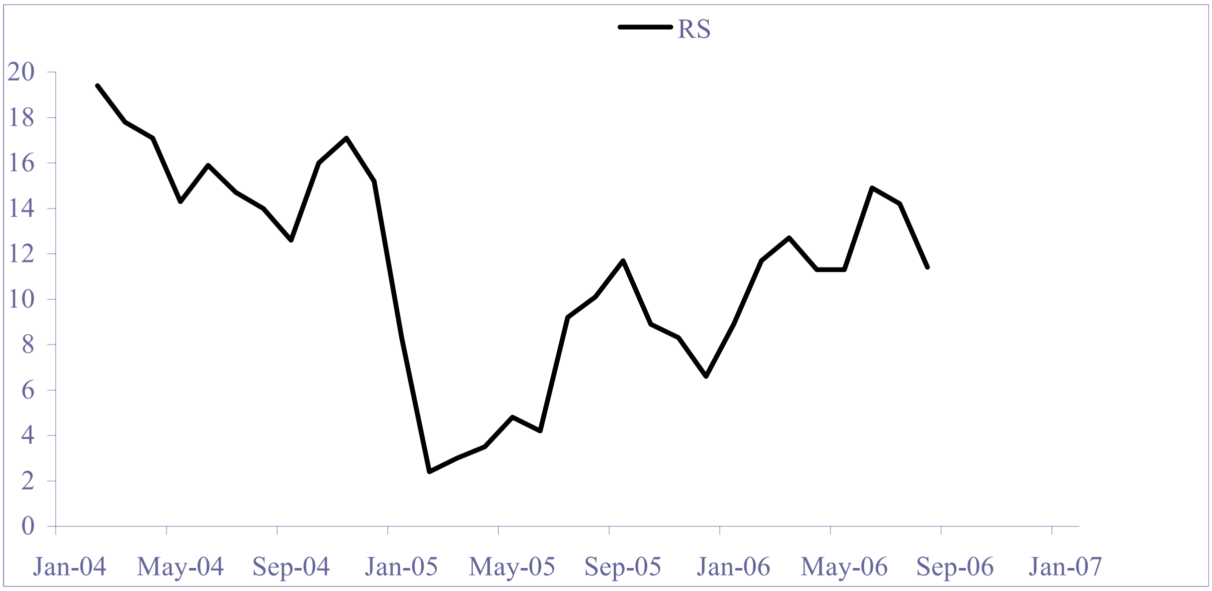


** From 2005 new methodology.*

Source: wiiw Monthly Database incorporating national statistics.

Figure 4. Labour productivity in industry, 2004-2006
year-on-year in %, 3-month moving average





Source: wiiw Monthly Database incorporating national statistics.

A noticeable feature of transition in the Balkans to date has been its failure to lead to re-industrialization, unlike events in the transition economies of Central Europe. However unconvincing industrial growth might be, except in Turkey and to some extent in Croatia, labour productivity growth can be seen to be relatively strong and persistent (see Table 3 and Figure 4).

Table 3. Labour productivity in industry change in % against preceding year

	1995	2000	2001	2002	2003	2004	2005	2006 1)		Index 1990=100 2006	Index 2000=100 2006
Croatia 2)	6.6	4.3	9.6	9.6	7.7	5.7	3.6	5.8	I-XI	210.8	149.9
Macedonia 3)	1.2	5.0	-0.2	1.4	10.8	4.6	11.9	6.8	I-X	166.1	140.2
Turkey 4)		8.8	-1.2	10.1	7.4	8.2	5.6	6.8	I-IX	.	142.7
Albania											
Bosnia and Herzegovina	.	10.2	12.7	4.2	17.3	14.4	11.6	.		.	.
Montenegro 3)	.	8.1	2.2	5.3	6.0	.	.	.		.	.
Serbia	.	16.9	4.1	12.7	10.9	12.5	9.0	12.4	I-X	.	179.3

Notes: 1) Preliminary. - 2) Enterprises with more than 20 employees. - 3) Excluding small enterprises. - 4) In manufacturing industry.
Source: wiiw Database incorporating national statistics.

Another indication of the region having entered the transition phase is the emergence of stronger incentives and competitive pressures to increase the efficiency of resource allocation. This trend can also be detected in the service sector. In Bosnia and Herzegovina, for instance, productivity growth in both the sector of market services and private industry has consistently outstripped wage growth since 2000. Similar developments are discernible in other countries, too; however, there may be some variances when it comes to services in those countries where tourism plays a significant role.

TRADE AND REGIONAL INTEGRATION EXPAND

In the past couple of years, exports have been growing faster than GDP in practically all countries in the region. Export growth has been particularly strong in Serbia: a growth rate of over 25% in 2006. Exports are also expanding in Bosnia and Herzegovina, as well as in Croatia. In Serbia, GDP growth is also driven by net exports, as import growth is slower than export growth, while the situation is perhaps not altogether clear in the other countries. To a certain extent, export growth is helped by the improvement of trade and business relations within the region. Business people cherish high hopes of the regional free-trade area, CEFTA, spurring trade and investment throughout the region as soon as it comes into being. This is particularly true of the countries with larger and somewhat stronger economies, such as Serbia and Croatia. Other countries, such as Bosnia and Herzegovina, fear that further liberalization of regional trade will be to the detriment of their production and export activities. As far as current developments are concerned, that does not seem to be the case.

Although exports are growing as can be seen in Table 4, trade deficits are chronically high or very high as shown in Figure 5.

Table 4. Foreign trade of Southeast European countries, EUR million (based on customs statistics)

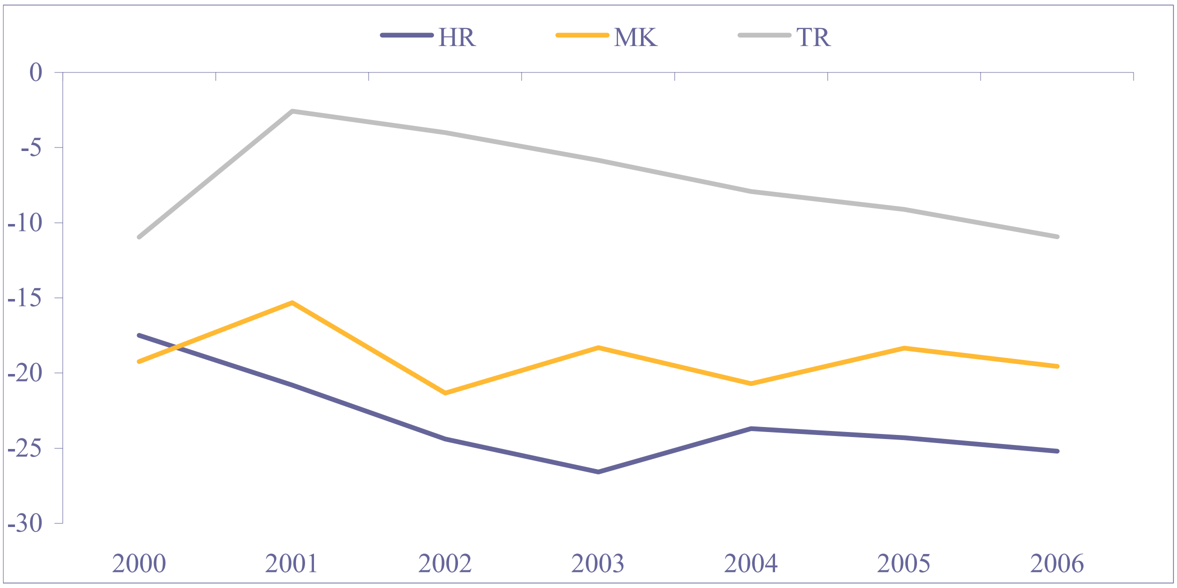
		1999	2000	2001	2002	2003	2004	2005	2006 [1]	2005	2006 [1]	
										change in %		
Croatia [2]	Exports	4027	4818	5210	5187	5468	6453	7065	8300	9.5	16.9	I-XI
	Imports	7324	8588	10232	11325	12546	13343	14935	17100	11.9	14.8	I-XI
	Balance	-3297	-3770	-5022	-6137	-7079	-6890	-7870	-8800	.	.	
Macedonia	Exports	1117	1431	1292	1181	1209	1348	1641	1912	21.7	16.5	
	Imports	1665	2266	1891	2111	2039	2358	2595	2997	10.0	15.5	
	Balance	-548	-835	-599	-931	-831	-1010	-954	-1085	.	.	
Albania	Exports	330	279	343	359	396	487	530	600	8.9	15.7	I-X
	Imports	1085	1185	1480	1589	1643	1849	2111	2500	14.2	16.2	I-X
	Balance	-756	-906	-1137	-1231	-1247	-1363	-1581	-1900	.	.	
Bosnia and Herzegovina	Exports	589	1115	1153	1068	1188	1441	1934	2640	34.2	36.5	
	Imports	2491	3452	3748	4115	4253	4758	5715	5818	20.1	1.8	
	Balance	-1902	-2338	-2595	-3046	-3066	-3317	-3781	-3178	.	.	
Montenegro	Exports	.	.	204	210	271	452	434	500	-3.9	15.0	
	Imports	.	.	594	593	630	869	940	1180	8.3	25.0	
	Balance	.	.	-390	-383	-359	-416	-506	-680	.	.	
Serbia	Exports	1270	1674	1897	2193	2441	2853	3617	5092	26.8	40.8	
	Imports	2694	3559	4754	5919	6603	8679	8470	10448	-2.4	23.3	
	Balance	-1424	-1885	-2858	-3726	-4162	-5826	-4853	-5356	.	.	

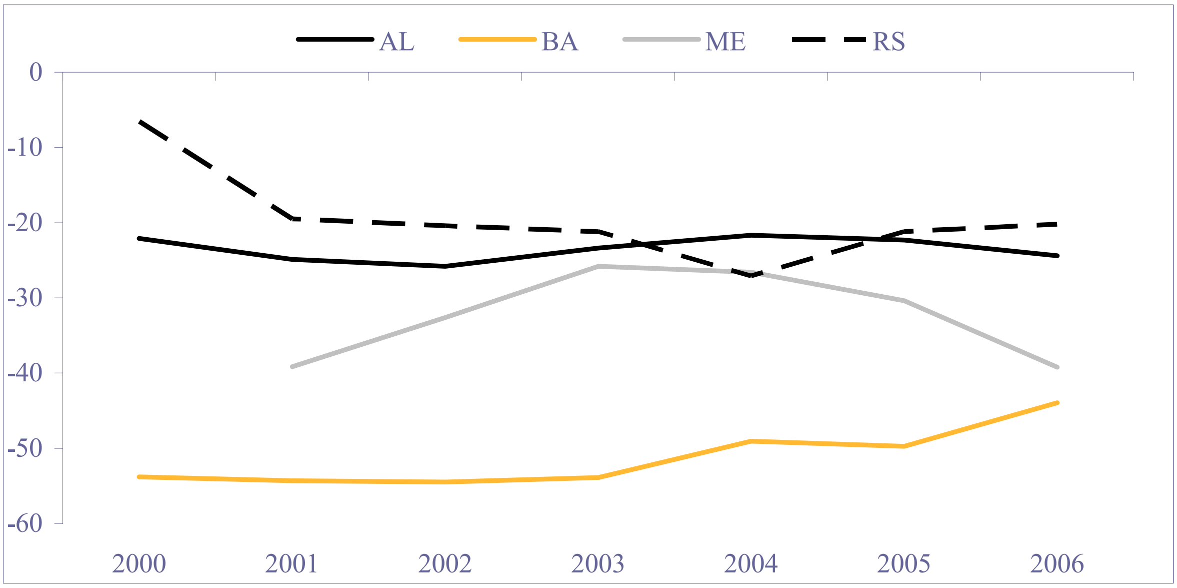
Notes: 1) Preliminary. - 2) From 2000 according to new methodology.
Source: wiiw Database incorporating national statistics.

These high trade deficits are a reflection of the rather weak recovery of industrial production; however, they are also a consequence of the increasing inflow of foreign investment. For instance, the deterioration of the trade balance in Montenegro can be attributed to the comparatively large inflow of foreign investment. Similarly, the volatility of the trade and current account deficits in Turkey is the consequence of volatile foreign investments. On the other hand, even with the increased inflows of foreign investments, the trade deficits in Serbia and Bosnia and Herzegovina have improved. In other countries, trade deficits have essentially remained at very high levels in terms of GDP (see Table 9 below).

In a number of countries in the Balkans, tourism is an important factor; trade in services thus contributes positively to the overall current account positions. In addition, as the region stabilized and political and economic developments improved, the inflow of remittances can also be seen to have increased appreciably. It is difficult to judge the extent to which the increase is due to better statistical coverage or to improvements in the banking system, e.g. greater trust in the banks' ability to handle private transfers. For all that, however, at least part of those greater inflows should be genuine increases.

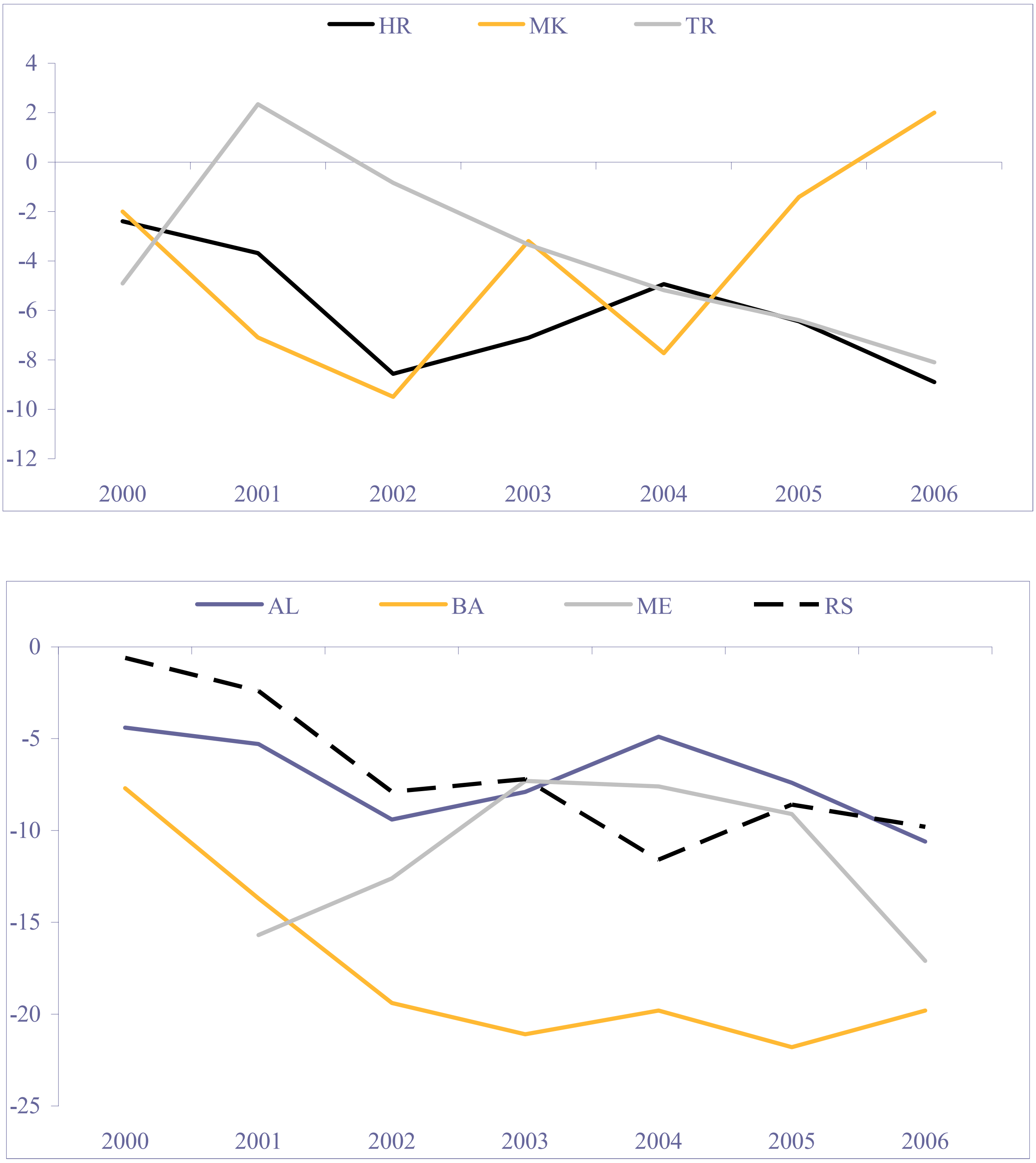
Figure 5. Trade deficit, 2000-2006 in % of GDP





Source: wiiw Database

Figure 6. Current account, 2000-2006 in % of GDP



Source: wiiw Database

Finally, decreases in aid flows, in some cases rather sharp decreases, have not led to deterioration in the funding of public expenditures or to problems in financing imports. In the case of Bosnia and Herzegovina, aid no longer plays all that an important role; however, the reduced inflow of aid-related resources has been more than offset by increased foreign investments. Indeed, in the next couple of years, the inflows of foreign investments are expected to increase markedly.

Developments in the current account are similar to those in the trade balance. In one case, however, the difference is quite dramatic. As can be seen in Figure 6, the Macedonian current account has improved rather strongly, culminating in a surplus. This swing of about 10% percentage points in terms of GDP has been attributed almost exclusively to the massive increase in private transfers. The extent to which that is a statistical artefact is hard to say. The improvement in the current account deficit of Bosnia and Herzegovina is consistent with the improvement of its trade balance; the same applies to Serbia as well. In all other cases, deterioration of current accounts is also aligned with similar developments in the trade balance. Only in the case of Croatia has the current account deficit deteriorated while the trade balance has not: both figures being expressed as percentages of GDP.

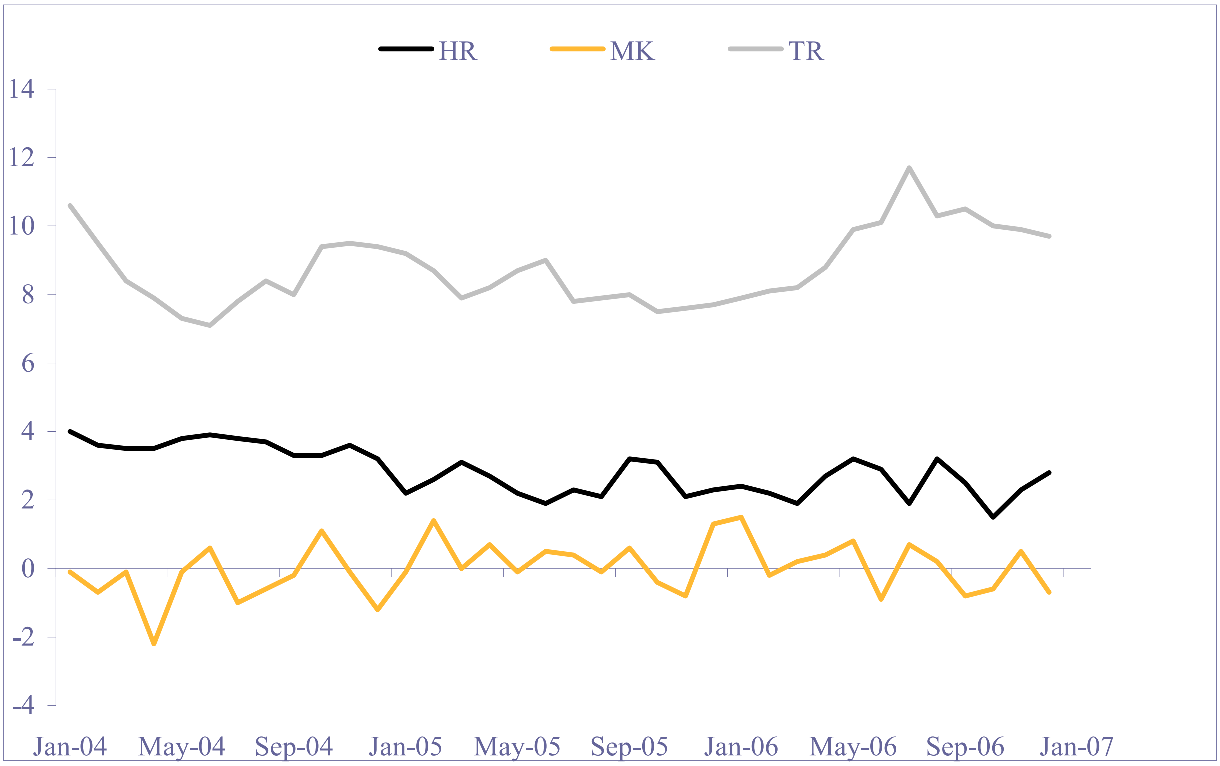
BUBBLE FEARS

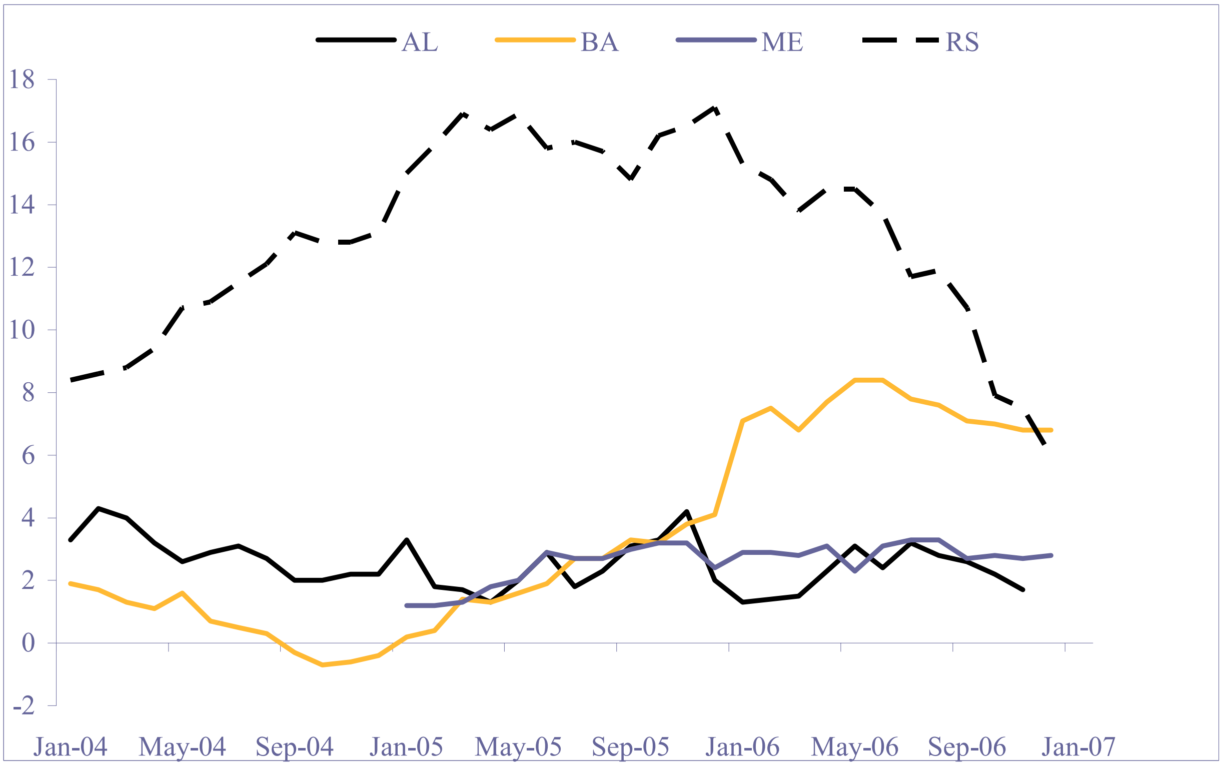
The region as a whole has remained rather stable in terms of prices. The sole exception is Turkey: in any event, a somewhat separate case. Even in the case of Turkey, the surge in inflation is not that strong given the exchange rate depreciation and the volatility of the capital markets. In the rest of the region, inflation can be observed to have picked up speed in Bosnia and Herzegovina; however, that is due to: (a) the introduction of VAT at the beginning of the last year; and (b) the relatively pronounced impact of higher oil prices. The expectations are that inflation will slow down this year. The only other country facing an inflation problem is Serbia. As can be seen in the second panel of Figure 7, inflation has been accelerating for the past couple of years, only to sharply decelerate in the second half of last year. As this is an interesting case, it should be entered into in greater detail.

The inflation pressure had its origins in rather lax fiscal policy backed by an exchange rate policy directed towards steady, though slow, currency depreciation during 2005. They combined to build up inflationary expectations that were running at around 20% year-on-year at the beginning of 2006. In anticipation of massive inflows of foreign investment, due to planned privatizations, and in the wake of the early elections, the government and the central bank decided to let the dinar appreciate; that led to a rather sharp drop in inflation. In addition, the government decided to defer increases in regulated prices and in the second half of the year used the drop in oil prices to reduce sharply the price of oil and gasoline. That was also intended as a ploy to secure votes for the governing parties in the upcoming parliamentary elections.

All those measures led to a rather sharp decline in the inflation rate. Year on year, however, inflation was still running at close to 12% (cost of living index) and over 13% (producer prices). It will probably remain at that or a slightly lower level this year given the corrections that will have to be made to administered prices. Moreover, the outcome of the elections was not all that decisive. This, in turn, may lead to the formation of a weak government that will have to tread gently on the spending of public revenues. It may also have to coerce the central bank into playing along, if by no other means than appointing a new governor.

Figure 7. Consumer price inflation, 2004-2006 year-on-year growth in %





Source: wiiw Monthly Database incorporating national statistics.

Table 5. Consumer price inflation
change in % against preceding year

	1995	2000	2001	2002	2003	2004	2005	2006	2007	2008
									forecast	
Croatia 2)	2.0	6.2	4.9	1.7	1.8	2.1	3.3	3.2	3	2.9
Macedonia	15.7	5.8	5.5	1.8	1.2	-0.4	0.5	3.2	3	3
Turkey	89.0	54.9	54.4	45.0	25.3	8.6	8.2	9.6	7	5
Albania	7.8	0.1	3.1	5.2	2.2	3.0	2.4	2.3	2	2
Bosnia and Herzegovina 3)	.	4.9	3.2	1.3	1.1	0.7	2.9	7.4	4	2
Montenegro	.	20.2	21.8	16.0	6.7	2.4	2.3	3.0	3	3
Serbia	.	79.6	93.3	16.6	9.9	11.4	16.2	11.6	10	10

Notes: 1) Preliminary. - 2) Up to 2001 retail prices. - 3) Costs of living.
Source: wiiw Database incorporating national statistics, forecast: wiiw.

Table 6. Producer prices in industry
change in % against preceding year

	1995	2000	2001	2002	2003	2004	2005	2006 1)		2007	2008
										forecast	
Croatia	0.7	9.7	3.6	-0.4	1.9	3.5	3.0	2.9		2.5	2.4
Macedonia	4.7	10.7	2.0	-0.9	-0.3	0.9	3.2	4.5		4	4
Turkey 2)3)	81.0	56.1	66.7	48.3	23.8	14.6	5.9	9.7		7	5
Albania 2)	.	6.5	-7.2	5.1	1.8	12.2	4.9	0.4	i-IX	.	.
Montenegro	.	.	.	14.5	4.5	5.8	2.1	2.0		3	3
Serbia	.	102.6	87.7	8.8	4.6	9.1	14.2	13.3		10	10

Notes: 1) Preliminary. - 2) In manufacturing industry. - 3) Wholesale prices.
Source: wiiw Database incorporating national statistics.

Though inflation is generally low and is expected to remain low (see Tables 5 and 6), fears abound that bubbles are bulging in many of the countries in the region. The data on real estate prices are not readily available; however, some sources have claimed, for instance, that within a year the real estate prices along the Montenegrin coast have caught up with those on the more developed Croatian coast. Similarly, real estate prices in Belgrade and Novi Sad, the capital of the province of Vojvodina in the north, are increasing significantly. Central banks in the region as a whole are keeping a close watch on the falling interest rates on debt and the sharp rise in equity markets.

It is hard to argue that a real estate bubble is building up in the Balkans. It is more likely that the prices are recovering from the very low level to which they had previously slumped, especially in areas that were beset by political conflicts or posed too great an investment risk on account of the precarious political situation in the country or region. The current leap in prices is thus most probably due to rapid recovery, rather than overinvestment. Moreover, as the banks are sound and stand relatively firm in the region as a whole, the central banks are falling prey to undue fear of a Ponzi scheme developing in the banking sector.

The bubble scare has come about not because the banks are offering too high an interest rate to attract deposits, but because they have been asking too low an interest rate on their loans. The fear is that all this will lead to households and enterprises accumulating unsustainable debts. If indeed the banks are incorrectly pricing the risks they face, it is difficult to determine the error of their ways. By most prudential standards, the banks' balance sheets can be declared to be quite sound. One possible culprit could be the exchange rate and the central banks' related monetary policy.

MONETARY POLICY AND EXCHANGE RATES

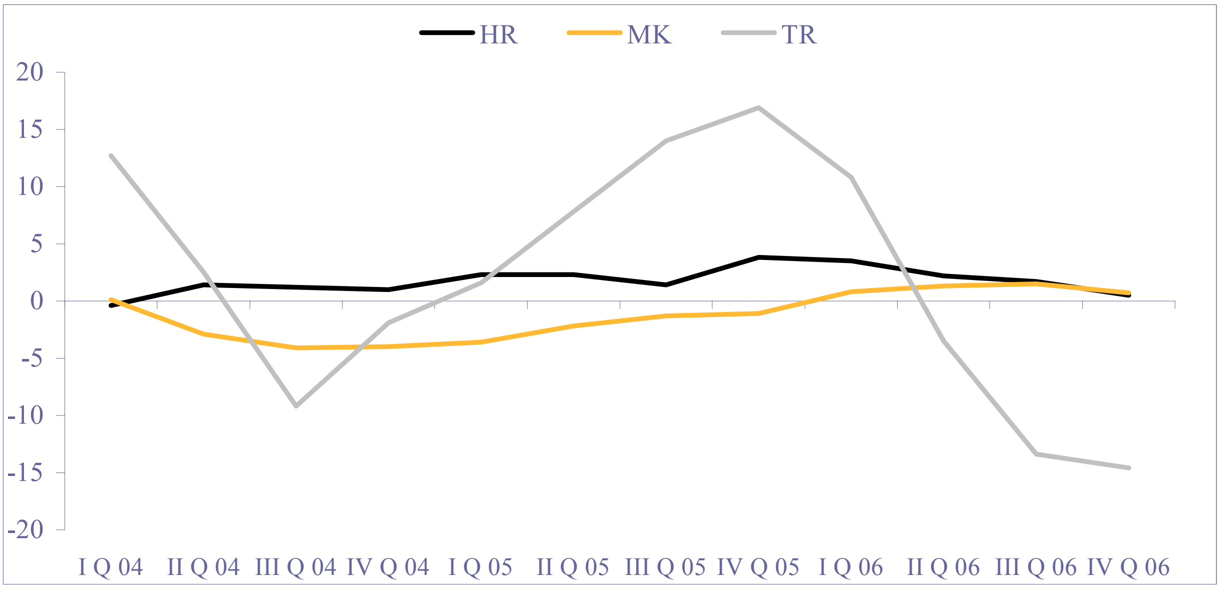
Despite most countries in the region applied fixed exchange rates, monetary policy is actively pursued, although in some cases it takes a somewhat unorthodox turn. It is unorthodox in the way its targets and instruments are chosen. In those cases where the exchange rates are more or less left to float, developments are slightly more dramatic, as can be seen from Figure 8. Turkey has experienced a sharp depreciation of its currency, together with an increase in interest rates. On the other hand, as already mentioned, Serbia has experienced a rather sharp appreciation of its currency. As an initial response, the Serbian central bank also put up its interest rate on short-term bonds and introduced punishing reserve requirements (as much as 60%) on foreign deposits. Albania, which also adheres to a floating exchange rate regime, has experienced slowing real appreciation and even some depreciation by the end of 2006.

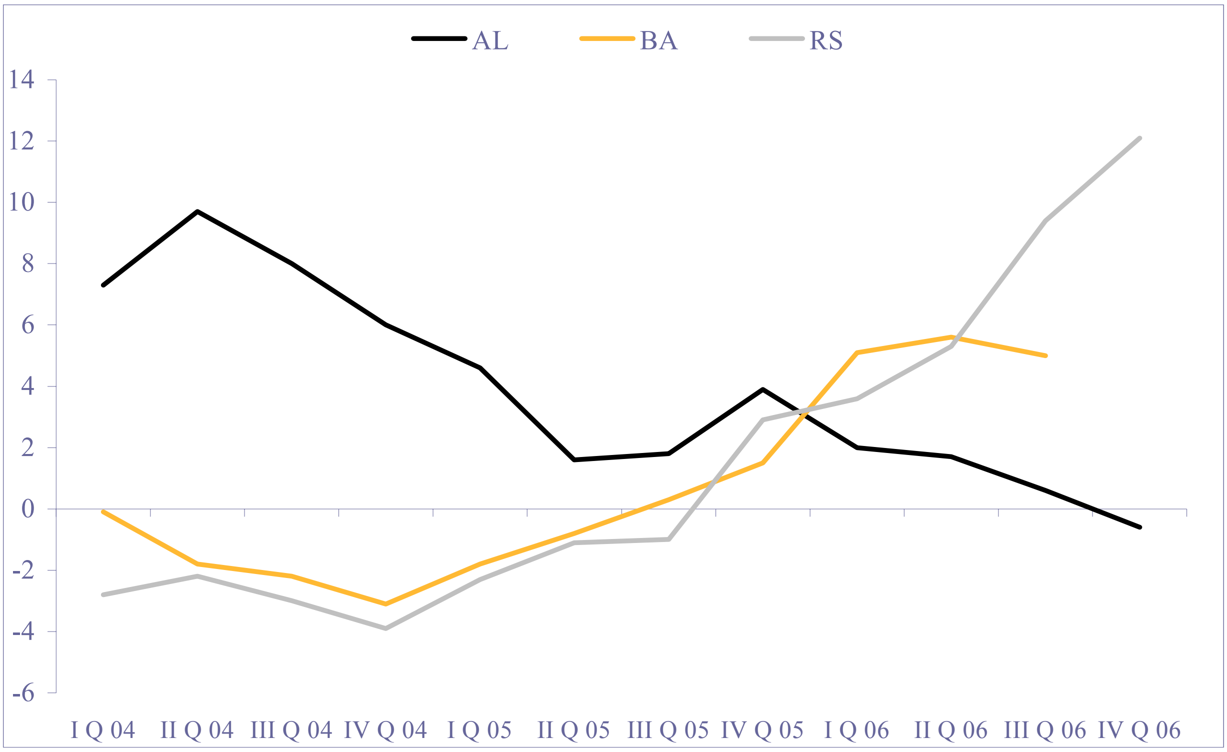
In the other cases, some real appreciation occurred as a consequence of a slight acceleration in inflation; however, the stability of real exchange rates has been essentially preserved. In the case of Macedonia, this has been achieved via a welcome relaxation of its monetary policy. In the past, the Macedonian central bank strove mostly to keep the exchange rate stable; the denar has been strictly fixed to the euro since 1997. It did that by keeping interest rates very high, even though prices for the most part took a deflationary tack. With the dramatic improvement in the current account, the central bank has relaxed its monetary policy significantly (Figure 9 does not reflect that adequately). This has borne mostly positive consequences for growth and the overall soundness of the financial system.

The story of the Croatian central bank is quite different. Despite having presided over a decade of price stability, its credibility has remained close to zero. The lack of trust is borne out by the massive deposits in euros, rather than in domestic currency, in Croatian banks (around 80%). Thus, rather than worrying about inflation which has kept level with the euro zone for quite a while, the central bank has become worried about the accumulation of foreign debt and the soundness of the banking system. As a result, it has intervened extensively to keep the exchange rate at a stable level, at the same time requiring banks to impose punitive reserve rates on their foreign currency deposits. As these measures proved ineffective, the central bank has now introduced quantitative restrictions on the amount of credit that banks and bank-like institutions can extend (12% per year). These restrictions on both the liabilities and assets of the banks have been extended to leasing companies; they may well be extended still further as the new measures are unlikely to be all that effective.

Unlike the Croatian central bank, which acts more as a financial watchdog, the Serbian central bank has finally found its vocation, at least in its public declarations. It is now determined to focus solely on the rate of inflation and resort to one single standard monetary instrument: using the interest rate to steer the money market. Officially, it is shifting towards inflation targeting. However, it has not yet abandoned the idea of extracting high reserve requirements from the commercial banks and other bank-like institutions, and it still intervenes heavily in the foreign exchange market. It has yet to indicate clearly the type of inflation it is in fact targeting. As a consequence, it is difficult to know whether it will in fact ever move towards inflation targeting. Once again it may even fall back on a fixed exchange rate policy that was all but reintroduced at the beginning of the year.

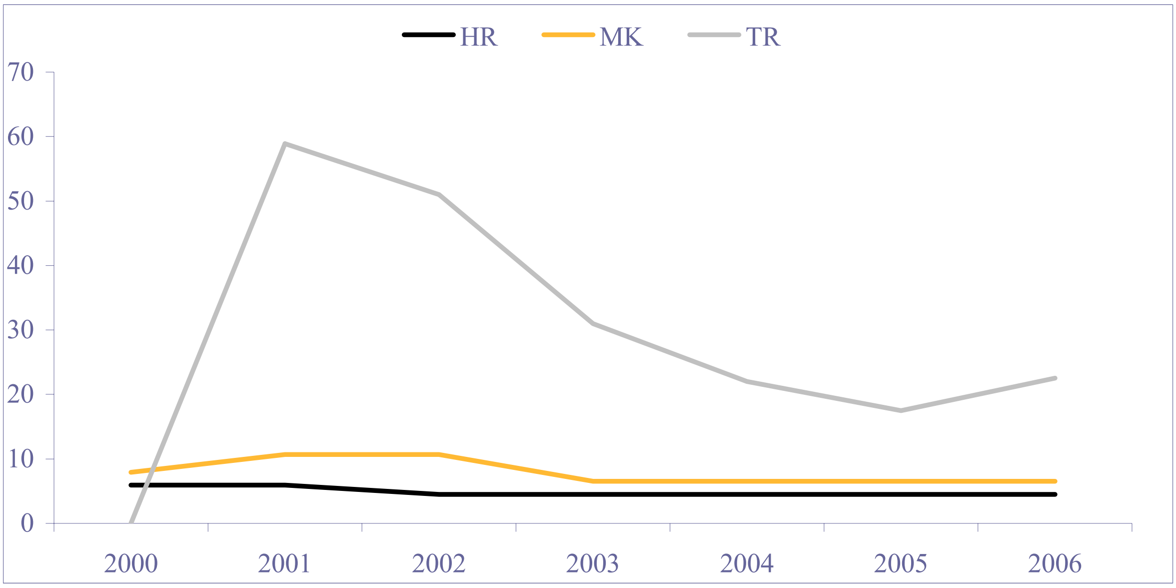
Figure 8. Real appreciation*, 2004-2006
EUR per NCU, CPI-deflated, year-on-year growth in %

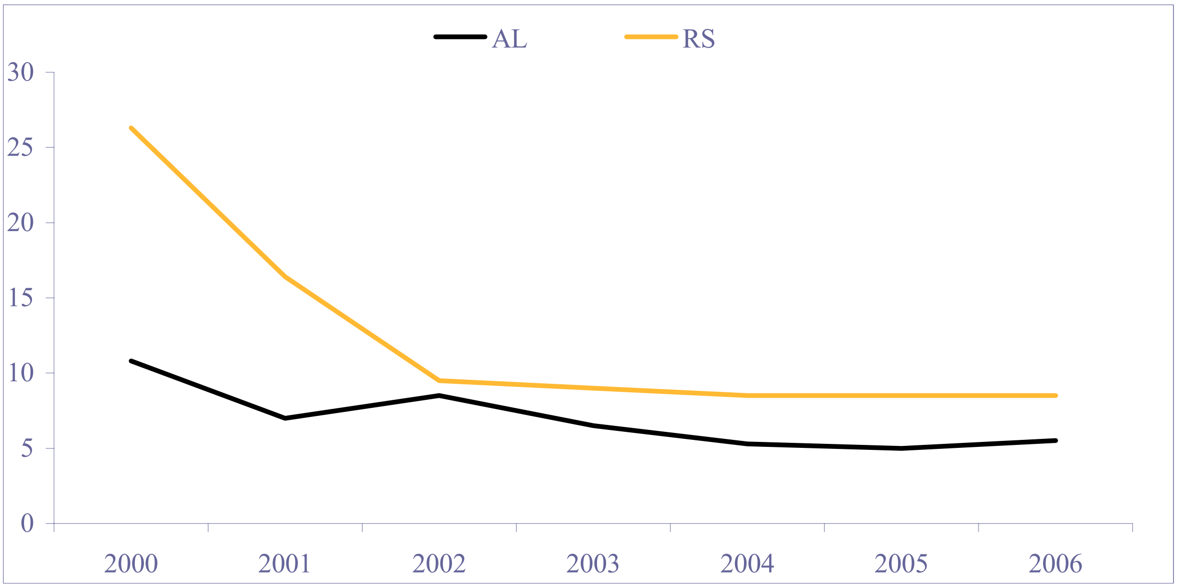




** Increasing line indicates real appreciation. Serbia: based on end-of-month exchange rates.*
Source: wiiw Monthly Database incorporating national statistics.

Figure 9. Minimum interest rates, 2000-2006
nominal NB leading rate in % p.a.





Note: AL data 2006 refer to November 2006.
Source: wiiw Monthly Database incorporating national statistics.

The more general problem with the monetary policy is that the direction in which it should in fact move is not altogether clear. If, given that to all appearances labour markets are not restricted and the wage-earners' bargaining power is weak owing to marked increases in productivity, it can be correctly claimed that the economy faces no real inflationary pressures, the reason for the tendency among central banks in the Balkans to adopt somewhat restrictive monetary policies is far from obvious. Also, as can be seen in Table 7, the monetization of the region is still rather low. In other words, the manner in which the higher interest rate policy might actually work remains obscure. Two concerns are usually mentioned in this connection, both of which are worth discussing here.

One worry is that it incurs the risk of a bubble developing as interest rates on loans go down. Thus, higher interest rates should keep the asset values down and so help to lower both investment and consumption levels.

However, as more capital accounts are opened thanks mostly to the ever growing presence of foreign banks, the resultant higher interest rates and low asset prices will merely attract larger inflows of foreign credit and investment. Under such circumstances, it is doubtful whether monetary policy can be a very effective foil against bubbles.

The other argument is that credit is expanding far beyond what is warranted by these countries' level of development. The logic of that argument hinges on the assumption that unavailability of credit is not a cause of underdevelopment in the first place. If, however, as Schumpeter argued, credit expansion spurs development, the relatively rapid growth of credit in the transition countries in the Balkans should be a welcome sign of risks lessening and opportunities for faster development increasing.

The final argument is that tight credit policy keeps a tight rein on fiscal policy. That argument is hardly applicable to the Balkans as the fiscal picture is relatively good there (see Table 8). In the sense of it possibly being a problem, improvement is probably beyond the reach of monetary policy. Bosnia and Herzegovina is a case in point. It relies on a currency board arrangement and is thus unable to pursue any orthodox monetary policy. The central bank has voiced concerns over credit expansion and its potential to undermine the currency board arrangement; like many other central banks in the region, it has started stepping up reserve requirements. A closer look at the economy of Bosnia and Herzegovina reveals that the risks lie elsewhere. On tracking the productivity and wage developments in various sectors, it appears that only in the relatively large public sector are wages increasing at a faster, indeed much faster, rate than productivity. In private industry and market services, wages are lagging far behind productivity. Thus, it is public spending that is threatening the stability of the exchange rate. As the government cannot, does not and (given the fiscal surplus) need not borrow from the central bank, monetary policy can in fact do nothing to curb public spending.

Table 7. Money supply, end of period

	National currency unit, bn									in % of GDP								
	1999	2000	2001	2002	2003	2004	2005	2006	1)	1999	2000	2001	2002	2003	2004	2005	2006	1)
Croatia																		
GDP	142	153	166	181	198	213	229	247		100	100	100	100	100	100	100	100	
Currency outside banks	6.0	6.6	8.5	9.7	10.6	11.0	12.2	14.6		4.2	4.4	5.1	5.3	5.3	5.1	5.3	5.9	
M1, Narrow money	13.9	18.0	23.7	30.9	33.9	34.6	38.8	48.5		9.8	11.8	14.3	17.0	17.1	16.2	16.9	19.6	
Broad money	56.7	73.1	106.1	116.1	128.9	139.9	154.6	182.5		40.0	47.9	64.0	64.1	65.0	65.8	67.5	73.9	
Macedonia																		
GDP	209	236	234	244	251	265	284	303		100	100	100	100	100	100	100	100	
Currency outside banks	8.2	9.5	14.1	14.1	14.2	14.2	14.4	16.2		3.9	4.0	6.0	5.8	5.6	5.3	5.1	5.3	
M1, Narrow money	19.7	22.4	25.3	26.4	27.3	27.6	29.7	34.7		9.4	9.5	10.8	10.8	10.8	10.4	10.4	11.5	
Broad money	35.1	43.7	71.6	65.0	76.7	89.7	103.9	112.6	IX	16.8	18.5	30.6	26.6	30.5	33.8	36.6	37.1	IX
Albania																		
GDP	481	533	590	629	694	752	822	880		100	100	100	100	100	100	100	100	
Currency outside banks	81.3	99.2	119.1	130.8	125.2	138.1	149.7	146.3	XI	16.9	18.6	20.2	20.8	18.0	18.4	18.2	16.6	XI
M1, Narrow money	103.0	124.0	142.9	152.7	144.7	172.8	227.7	226.9	XI	21.4	23.3	24.2	24.3	20.9	23.0	27.7	25.8	XI
Broad money	292.9	328.1	394.3	416.7	448.4	507.2	578.0	638.0	XI	60.9	61.6	66.8	66.3	64.6	67.4	70.3	72.5	XI
Bosnia and Herzegovina																		
GDP	10	11	12	13	13	15	16	18		100	100	100	100	100	100	100	100	
Currency outside banks	0.5	0.7	1.7	1.7	1.6	1.7	1.7	2.0		5.3	6.0	14.1	13.7	12.0	11.4	11.0	11.1	
M1, Narrow money	1.1	1.4	2.7	3.0	3.1	3.5	4.1	5.1		11.3	12.9	22.6	23.8	23.4	24.1	26.1	28.5	
Broad money 2)	2.2	2.5	4.7	5.1	5.5	6.8	8.1	10.1		22.2	22.6	39.2	40.1	41.2	46.6	51.3	56.6	
Serbia																		
GDP	210	398	784	1020	1172	1431	1750	2140		100	100	100	100	100	100	100	100	
Currency outside banks	6.7	10.9	25.3	43.7	43.0	45.2	53.7	68.4		3.2	2.7	3.2	4.3	3.7	3.2	3.1	3.2	
M1, Narrow money	14.8	27.0	58.2	93.8	99.5	111.2	144.9	200.0		7.0	6.8	7.4	9.2	8.5	7.8	8.3	9.3	
Broad money 3)	24.9	65.2	125.4	191.5	244.9	323.1	459.4	571.3	IX	11.9	16.4	16.0	18.8	20.9	22.6	26.3	26.7	IX

1) Preliminary. -2) Intermediate money M2 (M1+Quasy money). -3) Excluding frozen foreign currency saving deposits of households.

Source: wiiw Database incorporating national statistics

Table 8. General government budget balance, in % of GDP 1)

	2000	2001	2002	2003	2004	2005	2006	2)	2007 forecast	2008 forecast
Croatia	-6.5	-6.7	-5.0	-6.2	-4.8	-4.1	-3		-3	-2.5
Macedonia [3)]	2.3	-6.3	-5.0	-1.1	0.0	0.2	-0.6		-1	-1
Turkey	.	-33.0	-12.9	-11.3	-5.7	-1.2	-0.5		-1.8	.
Albania	-7.5	-6.9	-6.0	-4.9	-5.1	-3.4	-3		-3	-4
Bosnia and Herzegovina	-6.4	-3.2	-0.1	0.8	1.7	2.6	2		0	0
Montenegro [4)]	-6.0	-3.1	-2.8	-3.1	-2.1	-1.8	-1.6		-1	-1

Notes: 1) National definition; for Turkey EU definition: net lending (+) or net borrowing (-) according to ESA'95, excessive deficit procedure; for Croatia IMF definition. - 2) Preliminary. - 3) From 2001 excluding privatization revenues, 2005 data projected. - 4) Central government budget deficit.
Source: wiiw Database incorporating national statistics, AMECO; wiiw forecasts.

Although the relationship between the central bank and the fiscal authorities elsewhere in the Balkans is not the same as in Bosnia and Herzegovina, in principle the differences are not all that significant. Thus, monetary policy can do relatively little to curb fiscal policy, short of not supporting the stability of the exchange rate. This in essence is the policy adopted by the Turkish central bank. In the wake of the sharp drop in the exchange rate, it has put up its interest rate; the latter increase, however, is disproportionately smaller than the former depreciation. If the central bank had wanted to prevent a decline in the exchange rate, it would have had to increase its interest rates much more dramatically; that would have brought about a switch from a large surplus in the fiscal balance to a deficit. In view of the rather prudent fiscal policy that the Turkish government is pursuing at the moment, depreciating the currency seems the right course of action to take. It will increase the stock of foreign debt, thus dissuading the government from engaging in additional borrowing, while a stronger interest rate hike would have had the opposite effect by increasing the need for debt financing.

EXTERNAL BALANCES

Overall debt development has been an issue in a number of countries. It has also been a concern of the IMF, although it now plays a less prominent role since it no longer runs stringent programmes in the region (Turkey is an exception). Croatia and Serbia have reported major increases in foreign debt and its tendency to increase in terms of GDP and exports. As can be seen in Tables 9 and 10, debts are accumulating, despite the increase in foreign reserves. To an ever greater degree, however, it is the private sector share of those debts that is increasing. For their part, governments have been reducing their exposure to foreign debt. This raises two issues: (a) that of determining an acceptable level of debt for a transition economy with extensive foreign ownership in its banking and industry sectors; and (b) that of assessing the threat to exchange rate stability posed by the accumulation of private debt.

As to the first issue, it would appear that investors have raised the debt acceptance levels for those transition economies that are closely integrated with EU markets. Thus, although the level of Croatian debt has now surpassed 85% of GDP, the investment rating of its debt has not gone down. This may have been a problem for Croatia in a different way: due to the high level of foreign debt, moving to a higher rate of growth may be risky as it leads to a widening of the current account deficit and thus to further growth of foreign debt. Serbia's debt to GDP ratio is significantly lower; however, it has been increasing each year and will continue to do so as long as the rating agencies continue to downgrade their rating of the investment risks.

Table 9. Net capital flows
EUR million

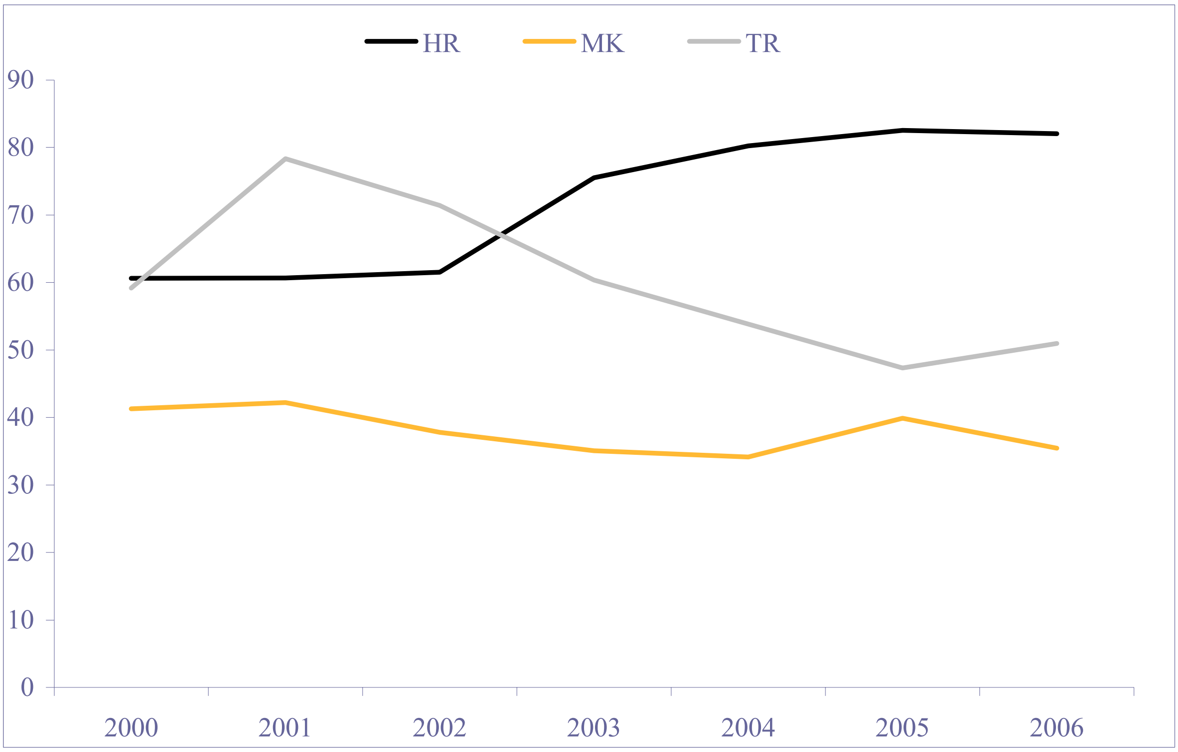
	Croatia					Macedonia				
	2003	2004	2005	*1-9/05*	*1-9/06*	2003	2004	2005	*1-10/05*	*1-10/06*
Capital inflow transfer	**4213**	**2385**	**3854**	***2383***	***3826***	**200**	**344**	**410**	**178**	**199**
Capital transfer	72	23	51	*8*	*-154*	-6	-4	-2	*-0.1*	*-0.3*
FDI	1678	708	1229	*1157*	*1658*	85	126	78	*70*	*269*
Portfolio	869	245	-1077	*-1015*	*38*	3	12	189	*31*	*47*
Other capital (loans)	1593	1409	3740	*2321*	*2285*	118	210	144	*77*	*-116*
Financial derivatives	.	.	-88	*-88*	*0*	.	.	.	.	.
Destination of capital inflow	**3101**	**1447**	**2816**	***888***	***1950***	**177**	**350**	**399**	**172**	**189**
Current account	1866	1404	1995	*485*	*1177*	132	334	66	*26*	*-93*
Increase reserves	1236	43	822	*403*	*773*	45	16	334	*147*	*282*
Errors & omissions	**-1112**	**-938**	**-1038**	***-1495***	***-1876***	**-23**	**6**	**-11**	*-6*	*-10*

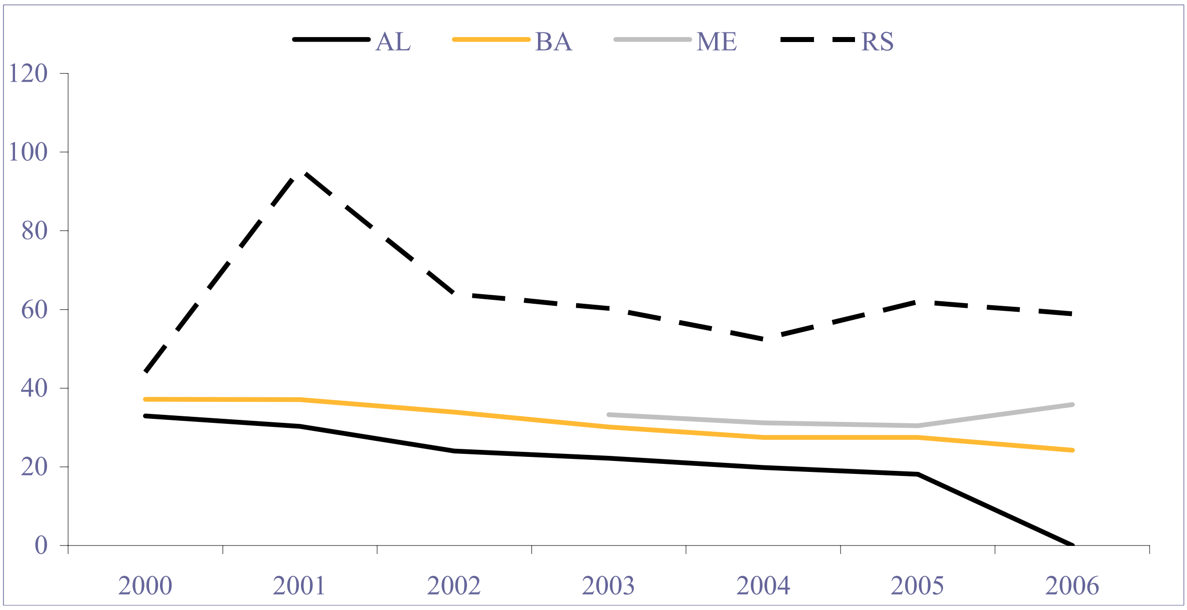
	Albania					Bosnia & Herzegovina				
	2003	2004	2005	*1-9/05*	*1-9/06*	2003	2004	2005	*1-9/05*	*1-9/06*
Capital inflow transfer	**318**	**415**	**440**	***220***	***293***	**1333**	**1498**	**1775**	***1112***	***926***
Capital transfer	139	106	99	*75*	*144*	411	401	367	*262*	*224*
FDI	158	269	222	*158*	*198*	338	533	420	*279*	*267*
Portfolio	-20	5	-2	*-7*	*23*	.	.	.	.	.
Other capital (loans)	41	35	120	*-6*	*-71*	584	565	988	*570*	*435*
Financial derivatives	.	.	.	.	.	.	.	.	.	.
Destination of capital inflow	**449**	**521**	**617**	***315***	***532***	**1600**	**1829**	**2135**	***1406***	***1126***
Current account	360	288	492	*271*	*411*	1439	1483	1758	*1158*	*785*
Increase reserves	88	233	125	*45*	*121*	162	346	378	*248*	*341*
Errors & omissions	**131**	**106**	**177**	***96***	***238***	**268**	**329**	**359**	*294*	*200*

	Montenegro					Serbia				
	2003	2004	2005	*1-6/05*	*1-6/06*	2003	2004	2005	*1-11/05*	*1-11/06*
Capital inflow transfer	**-42**	**36**	**366**	**260**	**241**	**2227**	**2474**	**3809**	.	**6732**
Capital transfer	.	.	.	.	*-13.2*	.	.	.	.	*675*
FDI	39	51	381	*228*	*149*	1204	777	1247	.	*2741*
Portfolio	1	6	5	*6*	*4*	.	.	.	.	.
Other capital (loans)	-82	-20	-20	*26*	*102*	1023	1697	2562	.	*3316*
Financial derivatives	.	.	.	.	.	.	.	.	.	.
Destination of capital inflow	**43**	**97**	**328**	**267**	**216**	**2116**	**2639**	**3443**	.	**6575**
Current account	102	120	154	*157*	*286*	1301	2279	1812	.	*2285*
Increase reserves	-59	-22	174	*110*	*-70*	815	360	1631	.	*4290*
Errors & omissions	**85**	**61**	**-38**	*7*	*25*	**-111**	**166**	**-366**	.	**-157**

Source: wiiw Database incorporating national bank statistics.

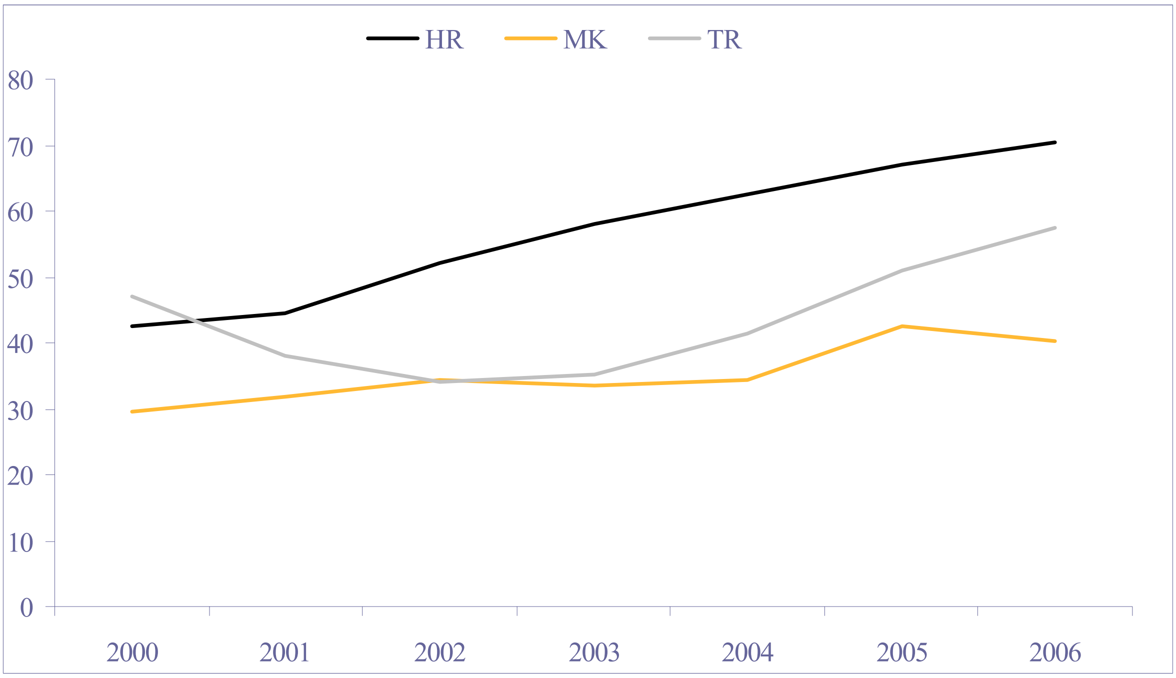
Figure 10. Share of total foreign debt in GDP, 2000-2006
in per cent





Source: National Banks of the respective countries.

Figure 11. Share of private foreign debt in total foreign debt, 2000-2006 in per cent



Note: HR, RS data 2006 refer to October 2006, TR data 2006 refer to September 2006.
Source: National Banks of the respective countries.

As for the second issue, exchange rate stability, the pressure is directed more towards appreciation than depreciation. Both the Serbian and (especially) Croatian central banks intervene in the foreign exchange markets in order to prevent their currencies from appreciating. Clearly the investors feel that the exchange rate is undervalued in terms of asset prices and, in the case of household loans, in terms of current wage levels (Croatia perhaps being an exception).

The issue of sustainability may thus turn out to be important, if the banks' assessments prove to be distorted as a result of some of the relevant relative prices being strongly skewed.

Table 10. Foreign financial position
EUR billion, end of period

	Gross external debt			1)	Reserves of National Bank (excluding gold)			2)	Current account			
	2004	2005	2006		2004	2005	2006		2005	2006	2007	2008
											forecast	
Croatia	22.8	25.5	29.0		6.4	7.4	9.0	XI	-2.0	-3.0	-2.9	-2.8
Macedonia	1.5	1.8	1.8		0.7	1.0	1.4	IX	-0.1	0.1	-0.1	-0.1
Turkey	130.5	137.5	157.9	IX	29.0	40.6	46.4	XI	-18.6	-27.6	-28.0	-30.0
Albania	1.2	1.2	.		1.0	1.2	1.3	XI	-0.5	-0.8	-0.7	-0.6
Bosnia & Herzegovina	2.1	2.2	2.2		1.8	2.1	2.9		-1.8	-1.8	-1.8	-1.7
Montenegro	0.5	0.5	0.6		.	.	.		-0.2	-0.3	-0.3	-0.3
Serbia	10.4	13.1	15.0		3.0	4.8	9.0		-1.8	-2.5	-2.8	-3.0

Notes: 1) General government foreign debt for BiH; Macedonia medium- and long-term; Gross external public debt for Montenegro. - 2) Albania: including gold; refer to total foreign assets of Bank of Albania.
Source: wiiw Database incorporating national statistics, forecast: wiiw.

SOCIAL RISKS

The rather positive picture created by productivity growth has a dark side: the low level of employment. It also has an even darker side: the high level of unemployment (see Table 11). The countries in the Balkans fall into different categories when it comes to the dynamics of unemployment. Croatia is gradually reducing its unemployment rate, although the employment rate is not really growing. Serbia, on the other hand, is undergoing a marked drop in employment and a rise in unemployment. Similar developments might well occur in Bosnia and Herzegovina, but not in Macedonia and Montenegro. Albania is also slowly reducing its rate of unemployment, probably on account of the large numbers of emigrants.

The case of Serbia is perhaps indicative of some of the ongoing processes in the region. Data on employment and unemployment point to a pronounced increase in employment in the private sector and a rather steep drop in both the public sector and agriculture. Since the private sector is smaller than the public sector in terms of employment, it follows that the overall level of employment is going down and that of unemployment is going up. Similar developments are to be expected in Bosnia and Herzegovina, where the public sector is still very large.

The social impact and sustainability of these developments are difficult to assess. In transition countries, political stridency tends to act as a substitute for social conflict. Governments thus tend to be weak and populist parties tend to secure significant shares of the vote. However, in some cases, viz. Serbia, social protest in the form of strikes and demonstrations serves as a bargaining tool in wage negotiations and has proven quite effective. In other cases, social protest has played more of a minor role for different reasons in different countries. Thus, some social risks still obtain in Serbia as the state sector undergoes further downsizing.

Table 11. Unemployment, LFS definition, annual averages

	in 1000 persons						rate in %				
	2001	2002	2003	2004	2005	2006 [1]	2004	2005	2006 [1]	2007	2008
										forecast	
Croatia	277	266	256	250	229	208	13.8	12.7	11.5	11	10.5
Macedonia	263	263	316	309	324	320	37.2	37.3	36	35	35
Turkey [2]	1967	2464	2493	2498	2520	2440	10.3	10.3	9.8	9.5	9
Albania [3]	181	172	163	157	155	150	14.4	14.2	13.9	14	14
Bosnia & Herzegovina [3)4)]	422	442	460	486	508	367	43.2	44.2	31.1	30	30
Montenegro [5]	58	58	.	72	78	77	27.7	30.3	30	30	30
Serbia [6]	433	460	500	665	720	760	18.5	20.8	22	23	24

Notes: 1) Preliminary. - 2) Civilian Labour Force. - 3) Unemployment by registration, end of period. - 4) From 2006 data based on the first LFS April 2006. - 5) From 2004 according to ILO and EUROSTAT, census 2003. - 6) 2004 according to ILO and EUROSTAT, census 2002.
Source: wiiw Database incorporating national statistics, forecast: wiiw.

THE KOSOVO ISSUE

Economies are improving in the Balkans, even though political risks persist. The major residual uncertainty is due to be resolved this spring when the decision is taken on the political status of Kosovo. The current time table requires that the plan proposed by the UN mediator, Marti Ahtisaari, be presented to the Security Council by the end of March. The Security Council is expected to vote in April on a new resolution in favour of adopting the plan or a variant thereof. Thereafter, the new EU and NATO missions will take up operations in Kosovo; the country will adopt a new constitution and file for membership in the international financial institutions, as well as in the United Nations. The financial institutions will act swiftly and accept Kosovo as a member; the World Bank in particular is expected to play a vital role in the reconstruction and recovery of the economy in Kosovo. UN Membership is expected to follow in September or soon thereafter.

The risk is that Serbia will not concur with this plan and Russia will support Serbia's insistence that Kosovo be granted internal, but not full external sovereignty. That may lead to a prolongation of the whole process with every possibility of the security situation in the province collapsing. On the other hand, political stability in Serbia may be put to a serious test if the independence of Kosovo is accepted by the UN or the EU and the United States, whereupon new early elections with a rather uncertain outcome would be the likely upshot. The EU, the United States and the more moderate parties that aspire to constituting the very core of the Serbian government are hoping for an outcome whereby the Kosovo independence process moves ahead as planned, with the Serbian government surviving, yet voicing its profound disagreement with the same.

OTHER POLITICAL IMPONDERABLES

The region has no lack of other political risks and uncertainties, although they are not as challenging as the Kosovo issue. Montenegro faces problems related to the adoption of the new, post-independence constitution and the impact it will have on parliamentary procedure. In Macedonia, the largest Albanian party is boycotting parliament as it objects to the smaller Albanian party having joined the governing coalition. In Bosnia and Herzegovina, the government in the Federation (one of the two political entities) has yet to be formed, six months after elections were held. Furthermore, the constitutional reform process is still being stalled. Tensions may well increase when the International Court of Justice in The Hague announces, as is expected, its verdict that Serbia and Montenegro were guilty or somewhat culpable of genocide during the war in Bosnia and Herzegovina in the first half of the nineties. Republika Srpska, the other political entity in Bosnia and

Herzegovina, will reject that verdict and possibly retaliate by cooperating even less than it does now in strengthening the functionality of the common state.

All these political shocks – and some relatively minor issues such as the upcoming parliamentary elections in Croatia – should prove manageable, but there is every risk of one or the other issue getting out of hand. If indeed, as expected, all the necessary decisions and changes are adopted and implemented, political stability should be strengthened and regional security improved. That should result in an improvement in the rather positive economic developments that have taken place to date.

EU INTEGRATION PROSPECTS

Stability and progress in the Balkans are closely linked to EU integration. All the countries in the region are at some stage or other in the association or accession process; the speed of both the individual and overall processes is of essential importance to the region's economic development and political stability. At present, the process is moving along at a relatively slow pace. It is expected that Stabilization and Association Agreements (SAA) will be signed with Bosnia and Herzegovina, Serbia and Montenegro in the course of the year. Kosovo will also be included in the process during this year. Croatia will continue to negotiate for membership, with a view to joining the EU around 2010. Macedonia will most probably not start to negotiate this year, although the process may pick up speed in the wake of the decision on Kosovo as that would prove a stabilizing factor for the region as a whole. The next step should be taken in early 2008 during the Slovene presidency. All the SAA countries are expected to apply for membership and Slovenia is expected to lobby heavily for a positive response by the EU. Certainly, the negotiations with Macedonia should start by then, at the latest.

The prospects of Turkey's negotiations for membership with the EU will depend on political developments in the EU; the outlook cannot be considered as positive at this point in time. No new moves in favour of including Turkey in the EU have emerged in any shape or form. Purportedly, enthusiasm for EU integration is waning in Turkey, and it is certainly absent in the EU. Whereas economic and even security-related considerations favour membership, the general public in the EU is not prepared to accept the idea and people in Turkey are quite dismayed. The short-term and even medium-term economic developments should not be affected by the slowdown of EU enlargement in the Balkans. The long-term consequences, however, may well prove negative, if Turkey's bid to join the EU is stalled indefinitely.

OVERALL PROSPECTS

In the short term, the economies in the region should continue to post good data. Growth should continue and most probably accelerate in some cases, viz. Macedonia. Price and exchange rate stability should not pose any problems. Exports should continue to grow, as should foreign investments. Political and social stability should be preserved, although some risks might arise in connection with the independence of Kosovo. EU integration should proceed at a pace that targets 2015 as the year for completing the enlargement process in the Balkans, with the exception of Kosovo. Turkey's accession, however, still seems to be shrouded in doubt.

MAX WATSON[1]: THE FINANCIAL SECTOR IN SOUTH EASTERN EUROPE:

Are there Lessons from Experience in the Converging EU Member States?"

The key messages of the Lisbon strategy are clearly relevant to Acceding and Candidate countries in South-Eastern Europe as they seek to accelerate growth and job creation and compete for foreign direct investment in a globalised economy. But in this region the role of the financial sector deserves special attention in strategies for economic development and real convergence. There are three reasons for this:

- When the financial sector is expanding rapidly, it is crucial to avoid the instability which, in the past, has often set back economic catching-up in emerging economies.
- Authorities need to be vigilant over banks' risk evaluation and pricing: rapid growth in foreign currency lending to unhedged borrowers may be symptomatic of issues here.
- Institutional structures need to support market-driven lending to small- and medium-sized firms, so that EU integration catalyses broadly-based growth and employment.

This paper therefore focuses on progress and challenges for policy-makers in these three areas: financial stability, efficient allocation, and SME financing.

It seems helpful to start by looking at some aspects of experience with financial convergence in EU Member States – especially current trends in the Baltic economies and Central Europe. With that as a reference point, we can then go on to consider the kind of challenges that can arise as financial sectors move towards their full potential in South Eastern Europe.

Of course, one cannot draw mechanical lessons across countries or regions. The economies of the Member States that joined the EU in 2004 vary widely; and there are major differences, too, in South Eastern Europe. Countries have advanced to differing degrees with reforms. And in the West Balkans ownership structures before the 1990s were quite distinctive. But across the formerly socialist economies there is a common experience of working to create modern and market-based financial sectors in a context of systemic transformation – and of applying the acquis communautaire on the road to EU Accession. So analogies can be suggestive.

EXPERIENCE IN CONVERGING EU MEMBER STATES

Experience with financial integration and convergence in the EU shows that this process can offer, potentially, a major support to growth and job creation. The recent past in the Baltic States underscores the scope for national investment and savings gaps to widen sharply, but in the opposite direction from recent trends in Asia or Latin America, where many economies are running surpluses as a form of reserves-based self insurance. While emerging economies in those other regions have taken steps to preserve national policy autonomy, converging EU members or candidates countries have made a different choice: to proceed with a limited pooling of sovereignty through common rules and mutual obligations. This seems closely linked to the confidence with which markets (and policy-makers) are countenancing, in some cases, wide external imbalances. At all events, the stylised "Feldstein-Horioka" facts of national investment and saving behaviour have been departed from in opposite directions.

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But financial development – within the broad framework of the acquis communautaire – needs to be prudently managed. This is not just a task for supervisors. It calls on a range of macroeconomic and structural policies. Recent experience in the EU underscores this also.

In the Baltics and Central Europe, policy reform has certainly not followed a cookie-cutter approach. One need only think of the radically different reform sequencing or monetary strategies adopted over time by Estonia, Hungary or Poland to see the variety. But there is a family resemblance in the way policy frameworks have evolved, and this has been important as a setting for financial sector development. One can perhaps pick out three elements that, with hindsight, have proved key in this regard:

- The complementarity of macroeconomic stabilization and structural reforms. Across the different approaches to sequencing reforms, this is a core factor that differentiates these Member States from reform efforts in some other "emerging market" economies.
- A commitment to use the acquis communautaire as a fulcrum for change, rather than just transposing it into domestic laws – though this effort has, of course, varied across countries in the quality and persistence of implementation over time.
- Enterprise reform and a strengthening of domestic competition. Comparing EBRD transition indicators (Table 1), or BEEPS indicators of the World Bank, these are litmus tests for the depth of progress in unlocking sources of growth and job creation. There was also marked progress in the non-bank financial sector and capital markets.

Table 1: Baltic States and Central Europe - Reform Indicators (2005)

	Progress in Restructuring		Cap Mkt/ Nonbanks Devpt.	Domestic Competition Index	Private Sector Role % Share
	Banks	Firms			
Estonia	4	4-	3+	3-	80
Latvia	4-	3	3	3-	70
Lithuania	4-	3	3	3	75
Czech Republic	4	3+	4-	3	80
Hungary	4	4-	4	3	80
Poland	4-	4-	4-	3	75
Slovakia	4-	4-	3-	3	80
Slovenia	3+	3	3-	3-	65
EU 8 (av)	4-	3(+)	3(+)	3	75

Rankings: 4 = Excellent; 1 = weak, Source: EBRD

This broad reform strategy has been crucial in creating an environment for the financial sector to flourish. And when we look at the current state of the sector in these Baltic and Central European Member States, we can see indeed a pattern of impressive progress. This positive side of the experience probably needs little elaboration here. It is evident in a strong growth of the financial sector in most cases; in typically high scores for financial and enterprise reform in the EBRD transition indices; and in the broadly favourable readings that emerge from IMF/World Bank Financial System Stability Assessments as well as recent central bank Financial Stability Reports. This is a historic achievement, in a short period.

But an issue that deserves probing more deeply is the nature of the credit booms currently underway in the region, which may flag new and potentially demanding challenges for policy. This issue, moreover, will be very relevant when we turn to the South East European setting:

- **Stability issues.** The Baltic economies have been experiencing an exceptionally rapid and sustained expansion of credit to the private sector, and all Central European economies have seen at least one period of rapid credit increase (Table 2). Credit growth during these episodes would be even more striking if cross-border flows were included. This is fundamentally an encouraging trend. But in one or two cases the pace of credit growth and asset price developments may be beginning to flash amber signals in terms of external and domestic dynamics. Even more clearly, though, an issue of potential concern is the proportion of new credit denominated in foreign currency, which suggests a rising level of unhedged borrowing and thus of balance sheet risks. This may be encouraged under fixed exchange rate regimes, which can lull concerns about exchange rate risk. In a country such as Estonia, to take one example, risks are indeed mitigated by a high quality of macroeconomic and structural policies, and potential for a fairly early exit to the euro. In Hungary, by contrast, there are policy mix challenges; the use of external savings is roughly equivalent to the deficit in the public sector; and euro adoption has been deferred. Credit growth must be evaluated in a broad economic and financial context.

Table 2: Baltic States and Central Europe: Financial Indicators (2005*)

	Annual Credit Growth	FDI % of Current Account	External Reserves/ S-t. debt	R.E.E.R. Apprecn. (3 years)	Average Bank Capital	FX Credit/ Total Credit
Estonia	32	84(P)	0.6	2	13	80
Latvia	38	33	0.3	-8	12	40
Lithuania	40	20	0.5	9	12*	60
Czech Rep.	8	200	0.7	7	13	30
Hungary	20	42*	1.0	21*	11	50
Poland	8	95	0.6	-26	14	30
Slovakia	14	200	0.9	20	22	20
Slovenia	16	(Surplus)	0.7	2	17	20

Sources: AMECO, IMF, National Sources. Period to end-2005 or latest available; in per cent
**Data for 2004 P=Provisional*

- **Allocation issues.** Technical measures of efficiency in intermediation have risen greatly. But at a macroeconomic level, the composition of lending raises questions about resource allocation. The most rapid growth, typically, has been in claims on households, especially mortgages. Consumption smoothing is, of course, natural in the presence of rising income expectations and a poor housing stock. But this pattern could be amplified by a setting, in some cases, of very low real interest rates and low risk premia, which might bias credit unduly towards consumption or real estate. Also, this credit composition may reflect still undiversified financial systems, and institutional settings where information asymmetries are high and the judicial process for enforcing claims on firms is still being strengthened. On the other hand, lending to firms (especially foreign subsidiaries) probably takes place heavily through cross-border channels, not captured in domestic credit data. More broadly, inflows of foreign direct investment are a counterbalancing force in resource allocation. This suggests a more balanced allocative pattern in the region.

These issues, of course, are not unique to Eastern Europe. Portugal (Box 1) illustrates the problems that can arise during a strong convergence boom in credit, particularly in a setting of easy fiscal policy. In a euro environment, foreign exchange exposure was not an issue in Portugal. But as the credit boom developed, allocation favoured households – and fiscal policy was lax. This was followed by very slow adjustment when the economy suffered an external shock, and when the private and public sector simultaneously hit leverage constraints. Real convergence stalled, with incomes stagnating for an extended period.

Box 1. The Credit and Fiscal Cycle in Portugal, 1998-2002

As interest rates in Portugal fell towards average euro area levels, and following financial reforms, credit to the private sector rose from 86 to 148 percent of GDP during 1998-2002. Monetary conditions corresponded to the overall situation of the euro area – so real interest rates were low relative to Portugal's cyclical position, and low also relative to the potentially high risk-adjusted returns in the real economy. (These conditions, of course, parallel those in a converging currency board country). With rising income expectations, consumption smoothing was supported by improved access to domestic and external credit. There was a strong supply response in housing, and no serious asset price bubble. In this environment, procyclical fiscal policy added fuel to the domestic boom, and the public debt ratio rose from 53 to 59% in 2001-2 (reversing the progress made in the previous two years). With demand outstripping supply, the external current account deficit exceeded 8%. The Bank of Portugal pressed banks to reduce reliance on short-term external funding, and strengthen their capital, to avoid market vulnerability. When fiscal correction became unavoidable, in 2002, it coincided with export weakness. The public and private sectors checked the rise in their debt simultaneously, compressing demand.

The upshot was that growth stalled, and an adjustment began in the real sector – including among borrowers from the banking system – that is still working its way through. In its domestic and external impact, this is not an extreme case of a credit boom (for example, in terms of real appreciation or asset price increases). But it required action by supervisors to check banks' funding vulnerability. And the strikingly procyclical role of fiscal policy ultimately damaged the process of sustained real convergence. Moreover, the heavy allocation of credit towards households meant that expansion had not incorporated a strong impulse to strengthen competitiveness in the productive sector. Plausibly, a greater effort to improve the flexibility of the real sector of the economy might have created alternative opportunities for the use of foreign savings that would have facilitated subsequent external adjustment. This illustrates aspects of market and growth risks during convergence credit booms, in a situation where national monetary policy is not available, and also some of the policy responses relevant to containing such risks.

In other words, the existence of EU-linked opportunities for financial integration and convergence does not guarantee that foreign savings will be wisely used, or that financial buoyancy will translate into sustained growth and job creation. These outcomes are tightly dependent on well-designed policies. The credit boom developments that attract the close scrutiny of policy-makers in the Baltic States or Central Europe – and more clearly the problematic convergence experience in Portugal – underscore that one must remain vigilant for financial risks to sustained growth and job creation. ". Indeed, the market term "EU umbrella" raises as many questions about possible moral hazards as it suggests connotations of stability in risk-adjusted returns. It is also clear that a hard peg or the euro do not in themselves insulate the economy from financial stress: they transform the channels through which stress can emerge – where relative prices adjust slowly at the end of a domestic boom, one can end up directly with a "growth crisis" (as in Portugal) instead of a "market crisis.

This experience of converging economies in the EU is potentially very relevant as we turn to South-Eastern Europe. The issues that have arisen map closely to priorities in that region of assuring financial stability, efficient allocation and also SME financing.

SOUTH EASTERN EUROPE: DEFINING THE FINANCIAL CHALLENGES

Against this backdrop, what are the key opportunities and challenges for policy-makers in South Eastern Europe, if financial sectors are to play a full role in fostering growth and job creation? While the region is diverse, some common features are striking. First and foremost, a major transformation of the financial sector is sweeping the region, and is far advanced in many countries. It is evidenced not only by the progress registered in institutional reforms but by the fast-expanding role of several West European banks that are active throughout Eastern Europe. This transformation underscores the strong potential of the sector to foster more rapid growth in the region. When one turns to the specifics in South-Eastern Europe on a country-by-country basis, these show encouraging features – but also challenges for the future:

- ***Monetary policy, and in a majority of cases fiscal policy also, has been strongly anchored – and the benefits of this for growth are now being reaped (Table 3).*** After stabilization programmes that embedded low inflation, economic growth has picked up across the region over the past four years. This clearly presents a favourable macroeconomic setting for financial sector development.

Table 3: South-Eastern Europe: Macroeconomic Stability and Growth

	GDP Growth		CPI Inflation		Fiscal Deficit (+)		Ct. A/C Def (+)	
	2004	2005	2004	2005	2004	2005	2004	2005
Bulgaria	6	6	6	4	-1	1	8	14
Romania	8	5	12	9	1	1	8	8
Croatia	4	4	2	3	5	5	5	6
Former Yugoslav Republic of Macedonia	3	4	0	1	-1	1	9	7
Turkey	10	5	9	8	6	5	5	4
Albania	6	6	3	2	5	5	6	7
BiH	6	5	0		2	0	25	19
Serbia	7	4	10	16	0	-1	13	10

Source: AMECO, IMF, EBRD. Data for 2005 are estimates in some cases.

- ***One watchpoint, though, is that external imbalances have widened quite sharply in some cases - particularly in Bulgaria, and in Bosnia and Herzegovina (BiH).*** As in the Baltic economies, this is an ambiguous development. Whether it is a potential source of sustained growth or of instability depends on the efficiency with which foreign savings are being used, and the composition of financing flows. In Bulgaria, for example, the recent widening of the current account has its counterpart in investment goods and energy imports, not consumer items. One should also note that in some cases the structure of external receipts is rather troubling, with a high dependence on transfers and loans, and a low level of exports of goods (which may also be in less dynamic sectors, or oriented to slower growing markets). These latter economies appear to be "under-trading." Future growth and stability in these cases will clearly depend critically on whether today's inflows of transfers and capital are being used to expand the productive sector: this in turn will depend in part on the efficiency of intermediation through the banking system.

- ***Progress with institutional deepening has varied (this being in some cases a legacy of regional conflict), and only the strongest performers in the region have already benefited from strong complementarities in macro and structural reform (Table 4).*** The critical areas for the financial sector are enterprise reform, including privatisation and the creation of more competitive domestic conditions; improvement in the broad institutional framework, and the diversification, of financial markets; and a continued deepening of financial supervision. EBRD transition indicators in the accompanying table suggest that enterprise reform has lagged behind banking reform, both absolutely and relative to progress in the Baltics and Central Europe. This picture will need to be refined and qualified in light of fine-focus surveys when we come to specific priorities for reform in the region, but it points towards the main areas where progress is needed.

Table 4: South-Eastern Europe: Selected Reform Indicators

	Progress in	Restructuring	Cap Mkt/ Nonbanks	Domestic Competition	Private Sector Role
	Banks	Firms	Devpt.	Index	% Share
Bulgaria	4-	3-	2+	3-	75
Romania	3	2+	2	2+	70
Croatia	4	3	3-	2+	60
Former Yugoslav Republic of Macedonia	3-	2+	2	2	65
Albania	3-	2	2-	2	75
BiH	3-	2	2-	1	55
Serbia	3-	2+	2	1	55
Average	3	2+	2	2	65
EU 8 Average	4-	3(+)	3(+)	3	75

Rankings: 4 = Excellent; 1 = weak, Source: EBRD

- ***Flows of FDI have been increasing, though there are marked differences across countries.*** A few countries (such as Romania, Bulgaria, Croatia) have been benefited from the bulk of recent inflows. Elsewhere inflows have been more modest and mainly directed to privatization opportunities and a limited number of consumer industries. An implication of this is that FDI, frequently, is not providing the same counterweight to consumer borrowing as in Eastern European Member States.

- ***Foreign banks have been entering an increasing number of markets, and credit is expanding rapidly.*** In some countries (such as Bulgaria) foreign banks own the overwhelming majority of the banking system. The balance of evidence suggests that this is a process that strengthens efficiency and managerial skills, as well as credit assessment and risk management approaches. On the other hand, it raises challenges for co-operation with home country supervisors. Local market developments (e.g., strong concentration on a few sectors such as residential and commercial real estate) may be “diversified away” in the global portfolio assessment of foreign supervisors.

- ***Lending to households is expanding particularly rapidly in most cases.*** This can promote income smoothing in the run-up to EU Accession; and, more tangibly, in the mortgage sector it can boost growth and job creation in a range of service industries and sub-contracting firms. A specific concern, though, is the currency denomination of credit to households, which is part of a broader issue familiar from the Baltics and Central Europe, and discussed further below. A more indirect concern is whether local conditions are causing a portfolio bias of banking activity toward household lending.

- ***The picture on lending for commercial purposes is mixed – particularly when one looks beyond foreign companies making direct investments, which typically enjoy ready access to cross-border finance from headquarters or home country banks.*** There are widely-recognised challenges in fostering more broadly-based growth in credit to domestic firms, particularly SMEs. One can argue, of course, that some countries – notably in the Western Balkans – still suffer from a concern about regional security that is inhibiting productive investment; and that trade links are not rebuilt. But these factors should be kept in proportion. Signs of confidence are evident in the growing investment in housing and the expansion of credit by foreign banks. So in the concluding section of this paper we will pay close attention to institutional quality, and to specific reforms that might help strengthen the contribution of the financial sector.

- ***Bank lending in foreign currencies (or indexed to foreign currencies) is emerging as a major issue, even though it is often not yet large relative to GDP.*** Some factors that encourage this are stronger than in recently acceded Member States, while an exit to the euro lies further in the future. There is, for example, less scope for external borrowing in domestic currencies than in Central Europe. Exchange rates in most cases are fairly or entirely rigid, which may foster unhedged borrowing.[2] In some countries (Croatia, Bulgaria, Serbia) a history of very rapid inflation left savers prone to dollarization – which has been followed (in Croatia, for example) by hysteresis.

- ***Financial stability indicators are typically reasonable, but potential risks across the region show a profile with some recurring features (Table 5).*** The most difficult issue to assess is rapid credit growth (often from a very low base). Thus far this has not fed through to strong real appreciation; but in some cases it is associated with widening current account deficits. One clear watchpoint is balance sheet exposure from foreign currency borrowing: current dynamics could leave economies vulnerable to parity changes or market depreciation. A second watchpoint, selectively, is leverage or liquidity of the public sector balance sheet – with total or external debt levels quite high in a few cases. More generally, countries could face stress if credit continues to expand rapidly but does not foster productive activities; and then competitiveness needs to be restored at the end of a credit boom. Financial stress could present in more than one form. With a floating exchange rate it might be a market crisis (amplified by balance sheet risks). With a hard peg, immediate risks would be to growth – but ultimately these could connect to banks via firm and household balance sheets.

Table 5: South-Eastern Europe – Financial Stability Indicators (2005)

	Annual Credit Growth	FDI % of Current Account	Ext. Res./ S-t. debt (Ratio)	R.E.E.R. Apprecn. (3 years)	Average Bank Capital	Credit: FX/ Total
Bulgaria	32	72	1.6	7	15	45
Romania	33	88	3.3	7	18	65
Croatia	12	60(P)	0.9	3	15	65
Former Yugoslav Republic of Macedonia	25	46	2.0	2	22	40
Turkey	33*	89	0.7	23	29	25
Albania	69(P)	61(P)	20	5	18	80
BiH	20(P)	34(P)	12	-5	18	Indexed
Serbia	63(P)	75(P)	2.8	2	12	70

*Sources: AMECO, IMF, National Sources. *2004 In per cent*

Drawing these elements together, where does this place countries in South Eastern Europe in terms of financial stability, allocative efficiency and support for SMEs? Clearly countries vary considerably. If there is a regional profile overall, it suggests two core concerns: whether the institutional setting is biasing credit away from productive activities; and whether risk managers are assessing balance sheet risk adequately. For country authorities, this would suggest a need to reflect on the way on which policy frameworks are influencing credit

[2] The main cases of significantly variable exchange rates are Albania, Romania and Turkey. Kosovo and Montenegro introduced the euro without formal arrangements.

growth. Depending how one assesses credit dynamics, the region – or certainly some countries within it – could be at a crossroads in terms of ensuring a healthy medium-term outlook for the financial sector.

South Eastern Europe: Towards an Integrated Financial Strategy

The regional profiles outlined above suggest challenges that cut across a range of policy domains. In each case, good outcomes will reflect not one policy instrument or initiative, but the joint impact of a range of policies. Notably, healthy credit growth or warranted asset price adjustments are a by-product of the way that macroeconomic and structural policies influence the economy through a range of channels. A "well-functioning financial sector" is a diffuse and elusive goal to pursue. Even "hard" financial variables such as credit growth, asset prices, or the real exchange rate are not something that policy targets (in a Tinbergen or Mundell-Fleming sense), and still less so is the quality or efficiency of aggregate credit allocation.

On the one hand, this makes it difficult to harness expectations in the pursuit of such a set of policies (by comparison with monetary stability or a balanced budget). On the other hand, there are strong complementarities to realise through these policy interactions – including that the overarching goals of financial stability and efficient allocation are mutually-reinforcing.

Let us first think how policies can combine to catalyse a scenario of well-balanced growth and job creation, and then imagine the opposite constellation. From this we can perhaps deduce specific challenges and trade-offs, and an integrated agenda for the key branches of policy.

In a benign scenario, sound macroeconomic policy and structural reforms foster high rates of return to capital. Together with consumption-smoothing, this results in external current account deficits that may be sizable, but are financed by stable capital inflows. Including a high share of FDI, these imports of savings induce beneficial microeconomic effects through improvements in know-how, technology spillovers, and more generally a ripple effect of job creation in local suppliers and second-round beneficiaries. A key transmission mechanism is efficiency in the financial sector, for which the legal and institutional framework creates an enabling environment. Risk premia act as balancing influence that keeps credit growth, capital accumulation and expanding consumption on a sustainable path. This helps ensure sustainable counterparts to the current account deficit and avoid financial volatility.

But there are financial sector risks, which could lead to an alternative scenario. The core concern is that market imperfections (notably: information asymmetries, moral hazard, and adverse selection) and pro-cyclical risk premia could lead to overly exuberant credit expansion in a setting of strong capital inflows. These influences could bias credit allocation towards real estate and consumption. Amplifying the normal financial accelerator, they could trigger asset price bubbles and balance sheet risks. At the macroeconomic level, the symptoms would be unproductive investment and unduly strong consumption, driving the current account deficit into unsustainable territory, financed by flows that become more short-term and volatile. Weak policies might fail to contain, or exacerbate, these risks. In such a setting, pro-cyclical fiscal policy or weak supervision could pour gasoline on the fire of the financial market accelerator; weak institutions could hamper lending to firms for productive purposes; and unhedged borrowers might take comfort from a setting of fixed exchange rates or monotonic nominal appreciation. At some point this exaggerated boom could go into reverse in a disruptive fashion, jeopardizing real convergence. The dangers to growth and jobs would be slow real sector adjustment, untimely fiscal adjustment; and, possibly, balance sheet risks.

Could these scenarios, perhaps, represent alternative branches that lie ahead in the financial road map of some economies in South-Eastern Europe over the medium term?

If so, it is valuable to map such challenges to the main instruments of macroeconomic and structural policy that affect the financial sector. So doing, we would need to face up squarely to several limitations in the off-the-shelf regime interpretations served to policymakers today:

- **Monetary policy.** The doctrine of "corner solutions" cannot be transposed blindly in this setting, even if hard pegs and inflation targeting do reduce the risk of speculative attacks. First, from the point of view of resource allocation and financial stability, one should not derive false security from hard pegs. A fixed rate regime raises the stakes for other policies to contain risks of balance sheet exposure in foreign currency (so that costs of a crisis do not rise to unacceptable levels even as its likelihood declines). A majority of Southeast European economies have rigid exchange rates, but they do not have the prospects of a rapid formal exit to the euro, so the scope for such balance sheet risks should be a major preoccupation for policy. Equally, it is important to ensure that a setting of low risk premia and real interest rates (under hard pegs) does not foster an underpricing of credit and a bias toward consumption and real estate. In turn, for countries with variable exchange rates, it needs to be borne in mind that domestic transmission mechanisms are still developing, and many loans are denominated or indexed in euros. For inflation targeting, one needs to reflect carefully on the responsiveness of output to interest rates, and on the role of the nominal exchange rate as a signal (especially in small, open economies). High financial and economic volatility could pose risks to the financial system and to growth. In sum, policy-makers must internalise the domestic risk characteristics of their monetary regimes, and consider how to address them. In this respect, an efficient, rapidly deepening and diversified financial sector is symbiotic with a sound monetary regime: to a high degree these are mutually-supportive priorities.

- **Fiscal policy.** Again, one needs to keep in mind the limitations of received policy frameworks. The Maastricht criteria, in particular, are concerned with nominal convergence and limiting fiscal risks in the run-up to monetary union, including externalities for other members. They should not be viewed as a set of guidelines to contain the demand pressures associated with a credit boom – or to assure, year-by-year, a sensible policy mix. (The reformed SGP goes further in that direction, with its emphasis on consolidation in "good times" and on avoiding pro-cyclicality.) Moreover, special care is needed in measuring the underlying fiscal position in a boom, when revenues may be swollen by transient asset price increases and a strong consumption weighting in GNP. The experience of Hungary in 2003 points to the risks of an unbalanced policy mix in terms of volatile capital flows and exchange rate instability. The evolution of Spain illustrates that moving toward fiscal balance at an early stage can delay the side effects of a credit boom on the external current account and real exchange rate, while building fiscal resilience against negative shocks. Experience in the Baltics underscores that credit booms and cross-border flows can drive the current account deficit to high levels even with a fiscal position close to balance. At the micro level, interest deductibility can add a problematic subsidy to real estate financing. And, last but not least, public debt management plays a role in shaping aggregate foreign currency exposure of the economy.

- **Supervisory policy.** This is clearly crucial in containing risks during rapid credit expansion. It is widely accepted that supervision must not be asked to substitute for other branches of policy – e.g., to serve as a surrogate for monetary autonomy. But this should not distract from an equally crucial concern: that supervisors need to internalise the implications of prevailing monetary and fiscal policy regimes for systemic bank behaviour. Where exchange rates are rigid, the pricing and risk assessment of loans to unhedged firms and households deserve close scrutiny. (Poland offers successful experience is this area, although it also raises the question whether supervision alone can exert a strong enough influence.) And, particularly where fiscal policy is procyclical, sharp attention is needed during credit booms to systemic risks that could arise from asset price bubbles or in sectors that may not be competitive in an undistorted relative price environment. Short-term external interbank borrowing (as in Portugal) also deserves careful monitoring. And, as noted earlier, liaison with home supervisors of foreign banks will also be key.

- **The broader institutional framework affecting the financial sector.** This is clearly very important in assuring a quality of intermediation that supports sustained growth and job creation. In this respect, one should not be discouraged by a blanket assessment that structural reforms in South-Eastern Europe are, uniformly, a quantum step behind high standards that prevail throughout the Eastern – or indeed Western – EU Member States. There is great scope to improve the institutional setting for financial markets, and the outlook for growth and jobs, through action targeted at a number of specific areas. What matters for sound credit allocation in particular is a subset of reforms (on which performance across the EU is indeed rather mixed). One litmus test is the ability to perfect and realise collateral, and the closely related field of entry and exit mechanisms for firms – including the design and judicial effectiveness of solvency procedures (Chart 1). These are elements that appear critical as regards the scope for SMEs to develop and to benefit from bank credit – and they bring us, of course, to familiar Lisbon territory. Over the medium term it will also be key to foster a diversified financial sector, including capital markets (to improve pricing, resilience, equity and local currency financing, public debt funding, hedging via derivatives and cross-border portfolio flows, and pension fund performance). In most of South-Eastern Europe it makes sense to think of access to regional or international capital markets as well as local markets (as in the Nordic-Baltic area): so cross-border institutional co-operation will be crucial.

Chart 1. Transparency & predictability - as rated by firms on policy uncertainty, upholding of property rights, administrative predictability, and corruption

	→ positive				
positive ↑	Favourable regulation: days for start-up, contract enforcement & insolvency; and labour market constraints	ALBANIA - -	BIH BULGARIA Former Yugoslav Republic of Macedonia ROMANIA	HUNGARY CROATIA SERBIA	+ + ESTONIA

Source: Index numbers developed on the basis of World Bank BEEPS Surveys

One key illustration how such policies may work in combination is with unhedged foreign currency borrowing by households and firms. Variability in the exchange rate can encourage hedging; fiscal management can help reduce domestic real interest rates and limit foreign currency exposure of the economy; supervisors (eg, through stress tests of indirect exchange rate exposure) can improve pricing and risk management, and consumer protection policy can alert borrowers to exchange rate risk. In a hard peg setting some of these routes become unavailable, and in some of the euro currency boards banks have been told they can run mismatched positions, thus, de facto, easing the availability of financing and engaging the viability of the financial system on the robustness of the peg. In this setting, the challenges for fiscal and structural policies become correspondingly steeper.

CONCLUDING REMARKS

The cup, clearly, is at least half full. A rapid, private sector-driven expansion of the financial sector is spreading across South Eastern Europe. And history leaves us in no doubt about the potential for financial development to go hand-in-hand with an acceleration of sustainable growth. But history has lessons, too, about possible risks to financial stability during such booms. And the profile of financial growth in the South Eastern Europe also prompts some questions about risk management and resource allocation that merit attention – particularly in light of the similar trends in the Baltics and Central Europe, and past experience in Portugal. It makes sense to focus sharply on the external sector symptoms of possible problems in credit growth (including the funding and domestic counterparts of the current account deficit); on incentive effects flowing from the chosen monetary regime; on aggregate balance sheet risks in the economy; and on the impact of fiscal policy on financial stability.

A point worth flagging, also, is the need to avoid the wrong type of policy response to such concerns. Direct controls (including temporary re-imposition of exchange controls) may be warranted as a circuit-breaker, but over time will distort credit and channel it towards less supervised intermediaries or less transparent routes. The same is true of very high levels of reserve requirements or capital ratios. Official intervention in credit allocation, of course, is to be avoided both on efficiency grounds and because of rent-seeking behaviour.

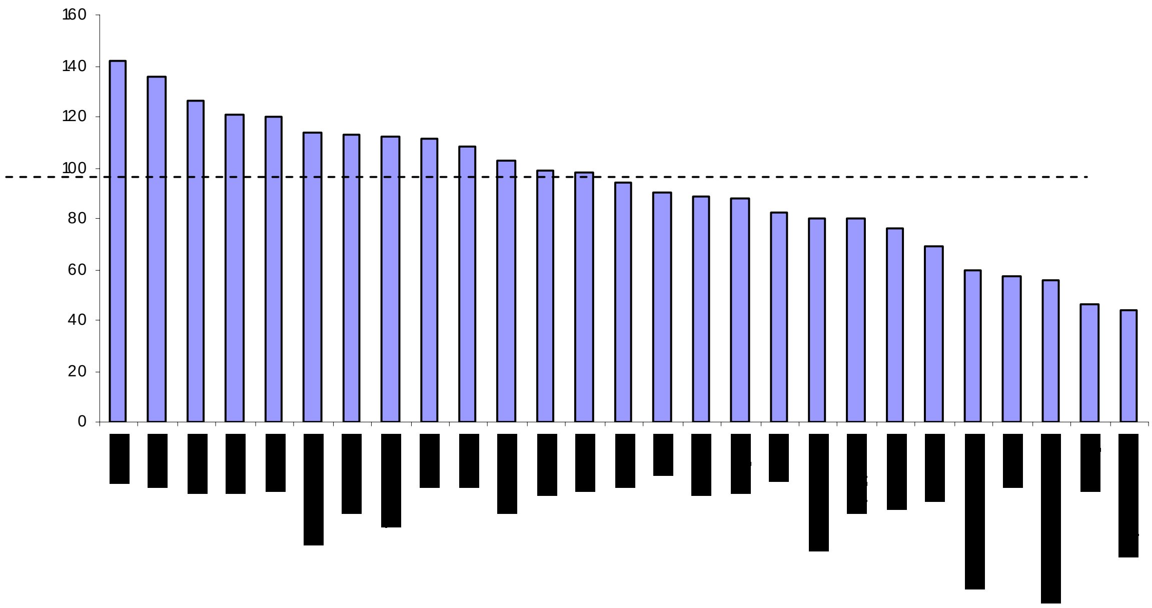
So the difficult message for policy-makers in South Eastern Europe, equipped in some cases with limited implementation capacity, is that healthy financial growth will depend on success across a range of policy areas. Diagnosis and targeting of reforms is all the more important. The good news is that progress in these domains can be mutually reinforcing, and that a healthy and expanding finical sector can help trigger pervasive effects on growth and job creation. So the returns to successful reform, potentially, can be very high indeed.

BEN SLAY, NICK MADDOCK, AND NEVENA KULIC[3]: MACROECONOMIC CHALLENGES AND GROWTH PROSPECTS IN SOUTHEAST EUROPE[4]

INTRODUCTION

The late start and uneven progress of the economic transition in many West Balkan countries has meant that the region as a whole has fallen well behind the countries of Central and Eastern Europe in joining the EU (a goal to which all aspire), as well as in economic performance more generally. As the trends in Figure 1 show, macroeconomic performance in most West Balkan countries (with the exception of Albania) compares quite unfavourably with the performance of other transition economies, particularly those of the new EU member states, but also vis-à-vis select CIS economies (such as Kazakhstan and Armenia) as well.

Figure 1: Real GDP in 2004 (compared to 1989)



Source: United Nations Development Programme (2006). National millennium development goals: A framework for action, Bratislava.

While the Central European and Baltic states acceded to the EU in May 2004 and Romanian and Bulgarian membership is expected in 2007 or 2008, of the Western Balkan countries only Croatia has hopes of an early entry. The Former Yugoslav Republic of Macedonia[5] is also now a 'candidate' (meaning that its application for membership has formally been accepted), and Albania has recently signed a Stabilisation and Association

[3] The authors are, respectively, Director, West Balkans economic reform advisor, and intern, at the UNDP Bratislava Regional Centre. This paper is an adapted version of Slay, 'Regional Growth Prospects Through 2015', *Development and Transition*, March 2006, pp. 2-5 (available at: http://www.lse.ac.uk/collections/developmentAndTransition/). It does not necessarily constitute an official statement of UNDP.
[4] The text of this paper was finished on 1 August 2006.
[5] Hereafter: 'Macedonia'.

Agreement with the EU. But for them, as well as for Serbia and Montenegro and Bosnia and Herzegovina, membership is a distant prospect, despite the fact that the latter two are negotiating Stabilisation and Association Agreements[6]. This is a 'waiting room' for membership which demonstrates progress but sets further targets before the European Commission will discuss membership.

Many observers believe that the most telling indicators of poor economic performance in the Western Balkans are the very high unemployment rates posted there which, in 2004, were 44% in Kosovo, 43% in Bosnia and Herzegovina, and 37% in Macedonia[7]. These rates partly reflect the very different context of early transition in the countries that emerged from former Yugoslavia. The destruction of physical and human capital because of war, coupled with elements of nostalgia and affection for the Yugoslav Federation, meant that the optimism which accompanied the changes in the new EU member states was missing. There has been much less of a bulwark of 'common purpose' to cushion the declines in output, incomes, and living standards that, as in other transition economies, arose at the start of the transition.

Despite this, policymakers in Southeast Europe have managed to get their economies growing, with annual GDP growth rates generally averaging 5% or above since the cessation of hostilities in Kosovo in 1999 (see Table 1). In Romania and Bulgaria, the benefits of anticipated EU membership, the reforms associated with the introduction of the acquis communautaire, and generally favourable conditions for investing in emerging markets are generating large inflows of foreign direct and portfolio investment. These countries, Croatia, and to a lesser extent, the West Balkan economies, now have hopes to capturing the virtuous circles of growth and reform from which the new member states have benefited since the mid-1990s.

Table 1: Regional Growth Trends

Region, country	Annual average GDP growth rates (see note)		
	1991-1995	1996-1999	2000-2005
New EU member states[8]	-5%	4%	5%
Accession countries[9]	-1%	-1%	4%
Western Balkans[10]	-5%	2%	4%
CIS	-11%	2%	8%
Overall	-7%	2%	6%

Note: unweighted averages.
Sources: National and Economic Intelligence Unit data and authors' calculations.

Economic growth does not, of course, automatically translate into poverty alleviation and sustainable human development. But without economic growth, prospects for improvements in human development are bleak. It is no accident that the World Bank's recent study on poverty shows that declines in absolute poverty have accompanied the post-1999 economic recoveries in the CIS and the Western Balkans[11]. As poverty rates are generally lower and unemployment rates higher in Southeast Europe than the CIS, attention in Southeast Europe is more often drawn to questions of 'jobless growth'.

[6] Negotiations for Stabilisation and Association Agreements started in both countries in 2005. See http://europa-eu-un.org/articles/en/article_5169_en.htm, and http://europa-eu-un.org/articles/en/article_4890_en.htm
[7] Mizsei, Kalman and Maddock, Nicholas (2005). Solving the unemployment crisis in the Western Balkan countries. Monitor, vol. 1, no. 8, September.
[8] The Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, and Slovenia.
[9] Bulgaria, Croatia, Romania, and Turkey.
[10] Albania, Bosnia and Herzegovina, Macedonia, and the Union of Serbia and Montenegro.
[11] World Bank (2005). Growth, poverty, and inequality: Eastern Europe and the Former Soviet Union. Washington D.C., November 2005.

This paper provides an overview of current and likely drivers of growth in Southeast Europe and examines structural reforms necessary to reduce unemployment. While its primary focus is on the Western Balkan 'inner circle' of Albania, Bosnia and Herzegovina, Macedonia, and Serbia and Montenegro, attention is also paid to Bulgaria, Croatia, Romania, and Turkey (which are at different stages in the EU accession process), and to the new member states as comparators.

GROWTH IN TRANSITION ECONOMIES

Southeast Europe's transition economies generally grow for the same reasons that all economies grow. These can be reduced to increases in the quantities of productive inputs—labour, capital (in its physical and human forms), and natural resources—as well as the introduction of new technologies and better management that raise the productivity with which these inputs are used. In addition, transition economies also experience what former Russian Deputy Prime Minister Yegor Gaidar has termed 'recovery growth',[12] which can be described as a mixture of cyclical recovery and the benefits of neo-Schumpeterian creative destruction. This recovery growth manifests itself in:

- bouncing back from the economic dislocation and military conflicts (in the Yugoslav successor states, Caucasus, Moldova, and Tajikistan);
- redeploying resources that had been trapped in inefficient uses during socialism; and
- improvements in the quality of the decisions made and policies implemented by nascent policy and governance institutions.

In addition, three other factors have played critical roles in the economic recoveries experienced in Southeast Europe since 1999: (i) favourable global and regional economic trends (particularly in terms of trade and investment flows); (ii) the continuing (if sometimes shaky) commitment to European integration and EU membership; and (iii) the absence of currency crises (often linked to de facto euroization).

Table 2: Geographic composition of exports (value terms, 2004)

Country	Export share of trading partner		
	South-East Europe and CIS	EU-25	Other
Albania	4%	84%	12%
Bosnia and Herzegovina	24%	72%	4%
Croatia	19%	64%	17%
Macedonia	45%	45%	10%
Serbia and Montenegro	5%	82%	13%

Source: http://stats.unctad.org/Handbook/TableViewer/tableView.aspx

Favourable global and regional economic trends. Every economy in the region relies heavily on global and/or regional economic integration, most obviously with the expanded EU. In many respects, the Southeast European economies have benefited from asymmetric access provided to the EU single market. As Table 2

[12] Gaidar, Y (2004). Recovery Growth and Key Features of the Current Economic Situation in Russia. Problems of Economic Transition, February, pp. 6-23.

shows, the expanded EU is now far and away the single most important market for merchandise exports for virtually all the West Balkan countries (although Macedonia is something of an outlier here).[13] If exports of such services as tourism and transport were included in this table, the shares would almost certainly be higher (particularly for Croatia).

Two sorts of objections have been raised concerning the extent and desirability of this geographic reorientation of trade. It may be that this reorientation has occurred at the cost of a certain amount of trade diversion, as barriers to intra-Balkan trade have not fallen as quickly as barriers to trade with the expanded EU. If correct, this argument points to the ineffectiveness of such mechanisms as the bilateral free trade agreements negotiated by the Stability Pact during 2003-2004, as well as their status vis-à-vis the World Trade Organisation (Bosnia and Herzegovina and Serbia and Montenegro are not yet WTO members). Still, these countries' anticipated WTO accession, as well as their eventual adoption of EU trading rules vis-à-vis one another, suggests that problems of trade diversion may be relatively short-lived. Second, Southeast European companies often point to the continued presence of tariff and non-tariff barriers to their exports to EU markets, particularly in such 'sensitive' sectors as agriculture and food products, textiles, steel, and shoes. These companies' abilities to take full advantage of the market access they do possess are also constrained by the EU's phytosanitary and veterinary standards.

Table 3: Current account balances as percentages of GDP

Country	2004	2005
Albania	-6.1%	-7.2%
Bosnia and Herzegovina	-24.7%	-18.6%
Bulgaria	-7.5%	-7.5%
Croatia	-4.8%	-5.0%
Macedonia	-8.2%	-6.5%
Romania	-7.5%	-8.7%
Serbia and Montenegro	-13.1%	-9.8%
Turkey	-5.1%	-6.4%

Source: EBRD transition report, 2005. Data for Turkey from national sources and Economic Intelligence Unit.

Croatia, Bulgaria, Romania, Turkey, and the new EU member states have dramatically increased exports based on large inflows of foreign direct investment (FDI), both to European markets and beyond. While the other Southeast European countries have yet to fully emulate this pattern, the benefits of the rapid growth in global trade in transport, tourism, and financial services are also being felt in the Western Balkans, notably in Serbia and Croatia. In addition to helping to modernise key sectors, these FDI flows are an important source for financing the West Balkan economies' large external deficits (see Tables 3, 4).

[13] Similar trends are apparent in the commodity composition of imports, although the role of the CIS countries is larger, due primarily to energy imports from the Russian Federation.

Table 4: Stock of FDI per capita, 2004 (US$)

Czech Republic	4,080
Hungary	3,693
Estonia	2,995
Slovakia	2,128
Croatia	2,049
Latvia	1,686
Slovenia	1,573
Poland	1,502
Lithuania	1,217
Bulgaria	1,071
Romania	747
Macedonia	577
Serbia and Montenegro	498
Albania	455
Bosnia and Herzegovina	437

Source: EBRD transition report, 2005.

European integration. The prospect of EU accession played a critical role in the transformation of the Central European and Baltic economies, particularly in terms of preparation for compliance with the EU's acquis communautaire (the body of laws and regulations to which member states must transpose national legislation) and for absorption of post-accession structural and cohesion funds. The gradual provision of asymmetric preferential access to the EU's single market and the introduction of accession-related reforms improved business and investment climates and helped to attract FDI and portfolio investment. These inflows have helped the new member states to withstand the competitive pressures of the single market, while simultaneously financing rapid growth in consumption and imports. They are now helping the new member states to transition from recovery growth to what might be called 'convergence growth', in which growth in foreign trade and investment in export-oriented sectors reflects the convergence of living standards and competitiveness toward levels found in other EU countries.

These lessons have not been lost on the Southeast European countries, which hope (with some successes in Croatia, as well perhaps as in Bulgaria and Romania—see Table 4) to repeat the new member states' achievements. The EU's commitment to the Western Balkan countries' eventual accession has endured—despite the uncertainties following the 2005 failure of the proposed EU constitution, the obvious weariness with further expansion in many EU countries, and widespread uneasiness about the financial, economic and cultural consequences of Turkey's potential accession. Negotiations with Croatia have been launched; Macedonia has been confirmed as a candidate country, and Stabilisation and Association Agreements are being negotiated with Serbia and Montenegro, and with Bosnia and Herzegovina. A focus on accession is expected to be a part of the negotiations on the future status of Kosovo and, for the Western Balkans overall, will help to reduce the political risk still perceived by investors and others.

Stable currencies. The currency crises experienced by Yugoslav successor states in the early 1990s, Bulgaria in 1996, Romania in 1997, and Turkey in 1999 and 2001 had strong, negative impacts on these countries' growth prospects. Sliding exchange rates boosted inflation and unemployment rates, cut into household incomes and spending, and raised poverty levels, while low confidence in national currencies threatened the solvency of healthy as well as weak financial institutions. The blocking of personal foreign exchange accounts in the early 1990s associated with depletion of foreign exchange reserves in many former Yugoslav successor states left a lasting.

Policy makers have responded to these shocks by paying considerable attention to building confidence in national currencies. The creation of independent central banks, pursuit of cautious monetary policies, and bank reform and restructuring, have been key emphases. The currency boards introduced in Bosnia and Herzegovina and Bulgaria, and the use of the Euro in Montenegro and Kosovo[14], are the strongest examples, since these regimes preclude discretionary monetary and exchange-rate policies. In practice, these economies' small size and openness significantly limits policy makers' short- and medium-term influence over real exchange rates. These monetary straitjackets can therefore be seen as recognitions of the inevitable. Further, if EU accession is indeed a viable medium-term prospect (as it certainly is for Bulgaria), the use of the Euro, or a rock-hard peg to the Euro via a currency board, may accelerate these countries' accession to the EU's Economic and Monetary Union and the formal adoption of the Euro.

By contrast, the Southeast European economies which have opted to formally retain monetary and exchange-rate policy discretion—Albania, Croatia, Macedonia, Romania, Serbia, and Turkey—are exposed to exchange rate risks that their neighbours do not have to face. In the worst case (i.e., pronounced misalignments between real and equilibrium exchange rates), attempts to use intermediate regimes in the grey area between 'truly fixed' and 'truly floating' exchange rates (so-called 'corner solutions') can make them more vulnerable to currency crises. The costs of defending misalignments (in terms of reserves spent) may also be very high[15].

It is nonetheless worth asking whether the use of discretionary monetary and exchange rate policy is necessarily a problem for countries with aspirations to EU membership and adoption of Euro. In many respects, it seems that the answer is no. The solid economic growth and low inflation rates these countries have posted since the uncertainties of the 1999-2001 period suggest that their monetary authorities are not facing insoluble problems. And anyway, Central banks cannot in practice stray very far from quasi-pegs vis-à-vis the Euro since some 70% of bank deposits by value in Serbia, and 87% in Croatia, are held in Euros[16]. The successes (thus far) achieved by central banks in Slovakia and Slovenia in negotiating their way into the European Monetary System (the EMU waiting room) without the formal surrender of monetary policy discretion, may offer some hopeful lessons in this respect—particularly in terms of preventing large fiscal imbalances and ensuring effective supervision over domestic financial institutions. For the larger economies in this group (Turkey, Romania), the relatively large share of non-tradables in GDP (and, hence, the more muted effects of nominal exchange rate changes on prices than is the case in more open economies), indicate that the monetary authorities may in fact enjoy some ability to influence real exchange rates in the short term (although in the medium and longer term, the growing importance of tradables will tend to diminish this).

These successes in monetary policy are helped by growing confidence in national currencies as a result of better prudential regulation, the increasing presence of foreign-owned banks, and the strengthening of domestic bank and non-bank financial institutions. This in turn is generating rapid growth in banking deposits in most Southeast European countries, allowing banks to lower real interest rates and offer more credit to domestic companies. This includes growing numbers of small and medium-sized enterprises in capital cites and major urban centres, although still almost never in rural areas or in agriculture. Mortgages are increasingly available, as are smaller loans for cars and other consumer durables, although long delays in obtaining collateral in the event of default still form a barrier to lending (hence the growing popularity of leasing).

Despite this, monetary policy makers in Albania, Croatia, Macedonia, and Serbia are likely to face further, and increasingly difficult, tradeoffs as the integration of their small open economies into the EU progresses. Their large current account deficits are for the moment funded by combinations of FDI and concessionary finance provided by international financial institutions, while favourable emerging market trends are helping to attract significant portfolio and other investment inflows. But this apparent immunity against external vulnerability and exchange rate risk need not last forever.

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[14] The Euro is being used as the domestic currency in Kosovo and Montenegro, without these territories' official inclusion in the Euro zone. This follows the precedent set with the German Mark, which had previously been a parallel and (because of widespread confidence) preferred currency in these territories.

[15] In contrast, under 'truly fixed' and 'truly floating' exchange rate regimes, there is no risk of currency crises since, in the latter case, exchange rates adjust to market conditions whereas, in the former, the economy adjusts to the supply of foreign exchange at the going exchange rate. While this adjustment may be problematic, it does not constitute a currency crisis.

[16] Sorsa, Piritta (2006). Macroeconomic challenges with EU accession in Southeastern Europe: an overview'. IMF working paper, WP/06/40, February, p.17. http://www.imf.org/external/pubs/ft/wp/2006/wp0640.pdf

Overall, the region's current economic circumstances suggest that recent growth trends need not quickly come to an end. On the other hand, a closer examination of the drivers of growth point to their time-bound nature. For example:

- 'Recovery growth' does not last forever: at some point, the gains from re-engaging idle or misallocated resources begin to diminish. The capacity to implement better economic policies is no guarantee of their actual implementation. The structural (as opposed to cyclical) nature of the high unemployment rates found in many West Balkan countries and the preponderance of long-term unemployment suggests that, because of progressive deskilling, the reserves of human (and other forms of) capital available to support continued growth may be thinner than they seem.
- 'Convergence growth' works well when exports from Southeast Europe occupy only a small fraction of the relevant segments of the EU's single market. But because the Euro region as a whole is growing only slowly (1-2% annually), sooner or later growth rates in countries that have hitched their stars to the EU will start to 'converge downward' towards these levels.[17] Moreover, while developing the state capacity needed to implement the *acquis communautaire* helped the new member states to move faster in reforms than would politically otherwise have been possible and to improve their business climates and attract investment, the adoption of such 'made in Brussels' regimes as the Common Agricultural Policy can be expected to reduce growth in countries that accede to the EU, or closely harmonise their policies to Brussels.
- Favourable global economic trends will not last forever. For example, the rapid growth in public and external debt accumulated by the Bush Administration could precipitate a sharp external adjustment for the American economy. Slower or negative import growth in the US would have a negative impact on exporters everywhere, including in Southeast Europe.
- *De facto* euroization in Kosovo and Montenegro and the currency boards in Bosnia and Herzegovina and Bulgaria have restored monetary confidence, lowered inflation, and facilitated financial deepening. But they do require fiscal probity in order to be fully effective; the collapse of Argentina's currency board in 2002 reminds us that monetary rectitude without fiscal adjustment can be a recipe for disaster. Fiscal imbalances could also put the Euro pegs employed in Albania, Croatia, Macedonia, Romania, Serbia, and Turkey under pressure, particularly if slow progress with structural reforms and FDI inflows limits the productivity growth needed to make real exchange appreciation sustainable.
- Energy prices may pose a short term threat to growth prospects. Though the threat is not as acute for Southeast Europe as it is for CIS, the Southeast European countries are still relatively energy inefficient, especially in heating and hot water systems and, in line with global trends, price rises are likely.

FROM GROWTH TO SUSTAINABLE DEVELOPMENT IN SOUTHEAST EUROPE

Exports have been a key factor in growth in most Western Balkan countries: all economies recorded annual double digit export growth over the last three years, with Serbia and Montenegro and Bosnia and Herzegovina leading in 2005, with the rates above 30%. Albania, Croatia and Macedonia were slightly behind their neighbours, but export growth was still around 20% annually[18]. This reflects in part FDI in export-oriented industries (notably steel, other metals, and food processing) and also growth from a low base. Exports vary from relatively high value-added products in Croatia, labour-intensive intermediate products (including textiles and footwear) particularly in Macedonia and Albania, and commodities (mainly metals and wood) in Kosovo

[17] Faster growth rates in the EU as a whole would be likely to require reductions in the share of GDP reallocation through the public sector to fund social protection schemes, increases in migration, and the further deregulation of many product and labour markets. Such measures do not seem very likely at present. Some observers have argued that demographic forces, structural rigidities in the EU economies, and the failure to resolve the EU's governance challenges following the defeat of the EU constitution in mid-2005 could lead the EU into a deep political and economic crisis. See, for example, David Mackie (2005) The Gathering EMU storm. JPMorgan Chase Bank, London, 9 September 2005.
[18] Source: EIU, country reports, December 2005.

and Bosnia and Herzegovina. Tourism is a key service export in both Croatia and Montenegro. Overall, the restructuring and technology transfer expected from stronger FDI inflows will be essential to sustaining the export performance in the region.

Growth in the Western Balkans is also being driven by the service sector, mainly finance, tourism, and transport. Albania, Croatia, and Montenegro enjoy significant potential for further development of tourism, particularly in terms of attracting higher-spending tourists through better facilities. Industry has lagged and, although individual sector performances vary between countries, there are positive trends in the metal and food processing industries, and in mining. Some of these were vertically integrated industries in former Yugoslavia and their resurgence suggests that the dislocation of supply chains and markets caused by the new international borders is being overcome. The expansion in Montenegro is being fuelled by the construction industry, which is linked to rehabilitation of the tourism sector.

Despite this strong export performance, external balance remains under threat in several countries (see Table 3). Deficits reflect growing imports for domestic consumption and of investment goods (a situation common to many transition and developing economies). Demand for investment goods is associated with the replacement of capital stock and the modernisation of newly privatised companies. The share of machinery in imports is large (2004: 25% Albania, 35% Croatia and 32%[19] in Serbia). Such deficits may be less of a threat if they reflect higher FDI inflows and boost exports, as was the case in many new EU member states. The situation is more difficult for Bosnia and Herzegovina, Montenegro, and Kosovo, which have a limited range of exports.

LABOUR MARKET STAGNATION

The strong post-1999 economic growth in the region has clearly not been a panacea; unemployment rates generally remain extremely high, particularly in Kosovo, Bosnia and Herzegovina, and Macedonia. Recent bouts of civil unrest in Kosovo and Macedonia are widely thought to have roots in unemployment. Economic growth and the anchor of European integration may not be sufficient to ensure more broad-based prosperity and sustained reductions in poverty in the medium term. Realising these growth opportunities and converting them into lower unemployment will necessitate overcoming structural obstacles.

Economic recovery in the Western Balkans has been described as ‘jobless growth’ and while this indicates solid growth in labour productivity and real wages, it also shows that the benefits of the recoveries are not widely spread across the labour force. Trends revealed by recent UNDP research in Macedonia, which is probably representative of many other Western Balkan countries, show that labour markets are indeed very stagnant. Job creation and job destruction rates[20] are very low compared to EU-8 countries now and at a similar stage in transition (see table 6). And while, as expected, the private sector does better than the public sector, the highest job creation rates are in enterprises employing up to 250 people. This means that job creation is still concentrated in the emerging private sector, and there has yet to be substantial successful grow-up into larger firms.

[19] Figures for Serbia and Croatia contain not only machinery but also transport equipment (See Economics Intelligence Unit country reports, December 2005).

[20] The *job creation rate* is defined as the sum of all employment gains in a given year expressed as a proportion of total employment at the start of the year. The *job destruction rate* is the sum of all employment losses in a given year as a proportion of total employment at the start of the year. *The job turnover rate* is the sum of the job creation and job destruction rates.

Table 6: Job creation and job destruction rates, selected transitional countries

	Macedonia 2002-2004 (a)	Macedonia 1996 (b)	Croatia 2001 (c)	Lithuania 1998-99 (c)	Bulgaria 2000 (d)
Job creation rate	1%	1.4%	4%	10%	7%
Job destruction rate	1%	7.4%	5%	10%	11%

Sources: (a) UNDP research; (b) Micevska, Maja; Eftimovski, Dimitar and Petkovska, Tatjana (undated). The failure of the labour market in Macedonia: a labour demand analysis; (c) Rutkowski, Jan (2003). Does strict employment protection discourage job creation: evidence from Croatia. World Bank Policy Research Paper 3104, August; and (d) Rutkowski, Jan (2003). Why is unemployment so high in Bulgaria? World Bank Policy Research Working Paper 3017.

This suggests that labour productivity 'catch-up' associated with earlier overmanning in state and socially-owned firms and reallocation of misallocated labour is still taking place. At the same time, enterprises are facing intensified competitive pressures in and from the emerging private sector, forcing them to reduce costs and employment and improve productivity. This points to low demand for labour, which is clearly at odds with the need to reduce unemployment. And while weak job creation rates rather than severe job destruction explain continuing high unemployment, evidence from other transition economies shows that higher job destruction rates are a sign of restructuring and efficiency gains—workers are moving to more productive employment, either within the same industry or to new industries as old ones decline. Overall, a vibrant labour market with higher rates of job creation, destruction and turnover is better in terms of economic growth and productivity and deals with 'misallocated resources' more effectively.

The Macedonian example underlines the importance of removing structural and legal barriers to job creation and hiring. The Western Balkan countries score generally badly in business environment surveys, suggesting that doing business in the region is still not easy. And because increasing the number of new firms is critical to job creation, efforts to improve the business environment could have a significant impact on unemployment.

High costs and complex procedures in dismissing workers associated with strict employment protection laws can also be a cause of labour market stagnation. If companies find it unduly costly to sack workers in response to changed circumstances, they are less likely to hire in the first place. Employment protection laws derived from a common base in the countries of former Yugoslavia and, given pressures to prevent dismissal of workers from socially-owned enterprises even after the start of the transition, gave high levels of protection to employees. Recent liberalisation has, however, put Macedonia ahead of many EU countries in terms of employment laws, striking a new balance between security and flexibility. Consistent with recent World Bank policy recommendations on labour market reform[21], this makes it easier to fire staff, allows private employment agencies to operate (although still with limitations), and removes virtually all limits on the use of temporary contracts.

Relatively high average wages. The Macedonian reforms were only introduced in 2005 and have not yet had time to fully take effect. They have generally not been replicated in other Western Balkan countries; for example, Montenegro's labour regulations still present costly and complex impediments to dismissal (mandatory severance pay is six monthly salaries regardless of length of service), limit the use of fixed term contracts, and curtail employers' ability to use overtime. Even in Macedonia, labour market reforms are not all-encompassing, with universal minimum wage still much higher compared to the average wage rate than in many other transition and some EU-15 economies[22]. This helps keep Macedonia's average wages high compared to Bulgaria and Romania, and probably explains part of Macedonia's (and other West Balkan

[21] World Bank (2005). Enhancing job opportunities: Eastern Europe and the former Soviet Union. November.

[22] The 2001 *Law on the payment of wages* specifies that the average salary cannot be lower than 65% of the average salaries of workers in industries covered by the same business code in the same month in the previous year.

countries') relatively poor performance in attracting FDI (a similar pattern of relative wage rates can be seen in other Western Balkan countries—see table 7).

Table 7: Average gross monthly wages (US$ equivalents, 2004)

Albania	**233**
Bosnia and Herzegovina	**474**
Croatia	**992**
Macedonia	**391**
Serbia and Montenegro	**359**
Bulgaria	**190**
Romania	**253**

Source: Kathuria, Sanjay (2005). Growth, investment climate and labour markets in the Western Balkans. Paper given at the Conference on labour markets, growth and poverty reduction strategies, Thessaloniki, Greece, May 27-28 2005.

Inflows of FDI are influenced by factor prices, particularly in the early stages of the transition[23] and, in short, the Western Balkans are uncompetitive. Although nobody wants to argue for lowering wages, the persistence of high average wages probably reflects the 'insider-outsider' effects of strict employment legislation, whereby highly protected workers in post are able to bid up wages beyond those justified by productivity gains because of the high procedural and financial costs of substituting other workers. The misalignment of wages with productivity is also likely to affect hiring and so to form a further impediment to job creation. These imbalances can perhaps be best addressed by the acceleration of structural reforms that can further boost growth in employment and labour productivity, while continuing to liberalise those labour market segments where the immediate payoffs are largest.

CONCLUSION

Compared to the EU-8, the Southeast European economies suffer from multiple misfortunes, linked primarily to the Yugoslav wars of succession, the currency crises of 1996-2001, and their late starts with the economic transition. Compared to the CIS economies, however, the countries of Southeast Europe possess critical advantages associated with their prospects for eventual accession to the European Union. The trends apparent since 2001 indicate that, when combined with market reforms, the benefits of proximity to the EU-25 and preferential access to the single market can attract the FDI needed to turn stagnation into growth. Whether this growth in GDP can be translated into growth in employment and reductions in poverty remains to be seen.

[23] Botric, Valerija and Skuflkic, Lorena (2005). Main determinants of foreign direct investment in the South East European countries. Paper given at the 2nd Euroframe Conference on Economic Policy Issues in the European Union, June 3rd 2005, Vienna.

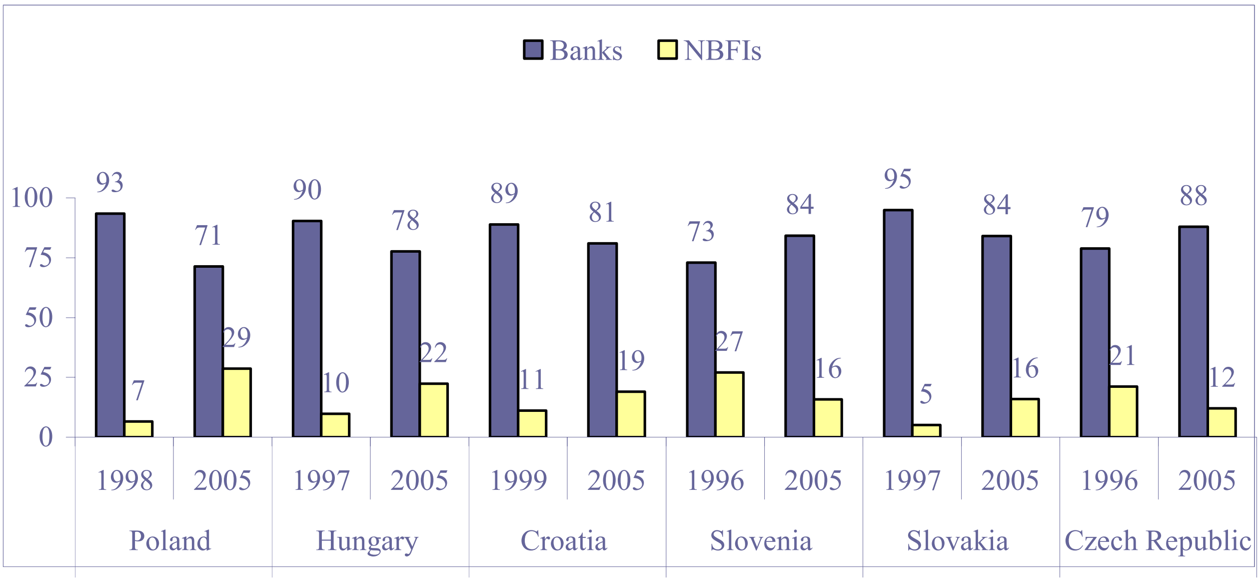
DUBRAVKO MIHALJEK[24]: FINANCIAL SECTOR DEVELOPMENTS IN CENTRAL AND SOUTH EASTERN EUROPE

This paper reviews the status of development of the financial sector in Central and South Eastern Europe and discusses some recent developments in the banking sector. The financial sector in the region is becoming less bank-dominated, but non-bank financial institutions are still largely underdeveloped. The banking sector itself is still underdeveloped compared to the euro area. How quickly this gap will get closed will depend partly on whether the recent credit boom achieves a soft landing. So far, the credit boom seems to have reflected for the most part rapid financial deepening and integration with EU economies. However, vulnerabilities that have started to build up in several countries need to be carefully monitored in order to ensure continued financial stability.

1. FINANCIAL SECTOR IN CENTRAL AND SOUTHEASTERN EUROPE

In contrast to the burgeoning literature on the banking sector, very little is known about the development of non-bank financial institutions in central and Eastern Europe.[25] With the exception of partial updates by the ECB (2006a and 2006b), the most recent comprehensive reviews of the non-bank sector date back to the early 2000s and cover the period through the late 1990s.[26] Since then, the structure of financial sectors in central Europe has generally shifted towards non-bank financial institutions. For the countries shown in Graph 1, the share of non-banks in total financial sector assets increased between the mid- 1990s and 2005 on average by 5½ percentage points, from 13½% to around 19% of GDP.

Graph 1. Banks and non-bank financial institutions in central Europe (in percent of total financial sector assets)



Sources: ECB (2006a and 2006b); European Commission (2005); central banks.

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[25] The paper will not discuss the development of equity and bond markets in CEE, as these topics are covered in EBRD (2006) and ECB (2006a and 2006b).
[26] See Hubmer et al (2001); Köke and Schröder (2002); Reiniger et al (2002); Schardax and Reininger (2001).

Among non-bank financial institutions, pension funds, insurance companies and leasing companies in Central Europe all recorded increases in total asset shares, while the share of investment funds declined (Table 1). The latter was especially the case in the Czech Republic and Slovenia, which explains the decrease in the overall share of non-banks in these countries between the mid-1990s and 2005 (Graph 1). The non-bank sectors are on the whole larger in Central Europe than in South Eastern Europe (19% vs. 15.4% of total financial sector assets in 2005). Insurance companies and pension funds tend to be more developed in Central Europe, and leasing companies and other non-bank financial institutions in South Eastern Europe. Investment funds are of similar size in both regions.

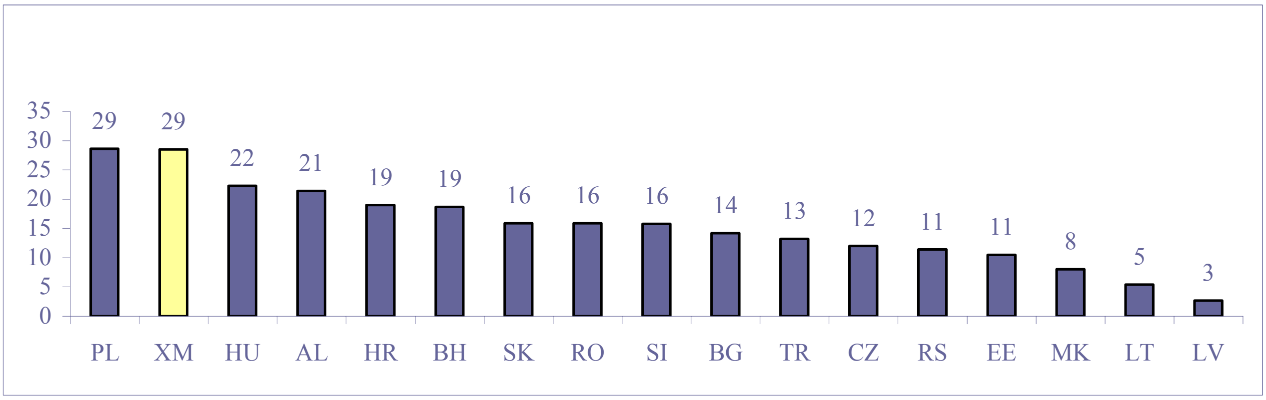
Table 1. Structure of non-bank financial sectors in central Europe
(In percent of total financial sector assets)

	Central Europe[1]			South-eastern
	1990s[3]	2005	Change (%	2005[2]
Insurance companies	5.2	6.8	1.6	3.7
Investment funds	6.3	4.7	–1.6	4.2
Pension funds	0.4	4.3	3.9	2.0
Leasing companies and other NBFIs	1.6	3.2	1.6	7.0
Non-bank financial institutions	***13.5***	***19.0***	***5.5***	***15.4***
Banks	***86.5***	***81.0***	***–5.5***	***84.6***

1 Average for Croatia, the Czech Republic, Hungary, Poland, Slovakia and Slovenia. 2 Average for Bulgaria, Croatia, Romania and Turkey. 3 Average across different starting years (see Graph 1).
Source: Author's estimates based on central bank data.

With the exception of Poland, the non-bank financial sector in CEE is still fairly small: around 15½% of GDP on average for 16 countries in the region, compared with 29% on average in the euro area (Graph 2). Interestingly, the correlation between the size of the non-bank sector (in percent of financial sector assets) and some indicators of overall development (such as per capita GDP) seems to be weak. For instance, Albania and Bosnia and Herzegovina, whose per capita income is among the lowest in CEE, have large non-bank sectors relative to their total financial sector assets; while the Czech Republic and Estonia, whose per capita income is among the highest in CEE, have relatively small non-bank sectors.

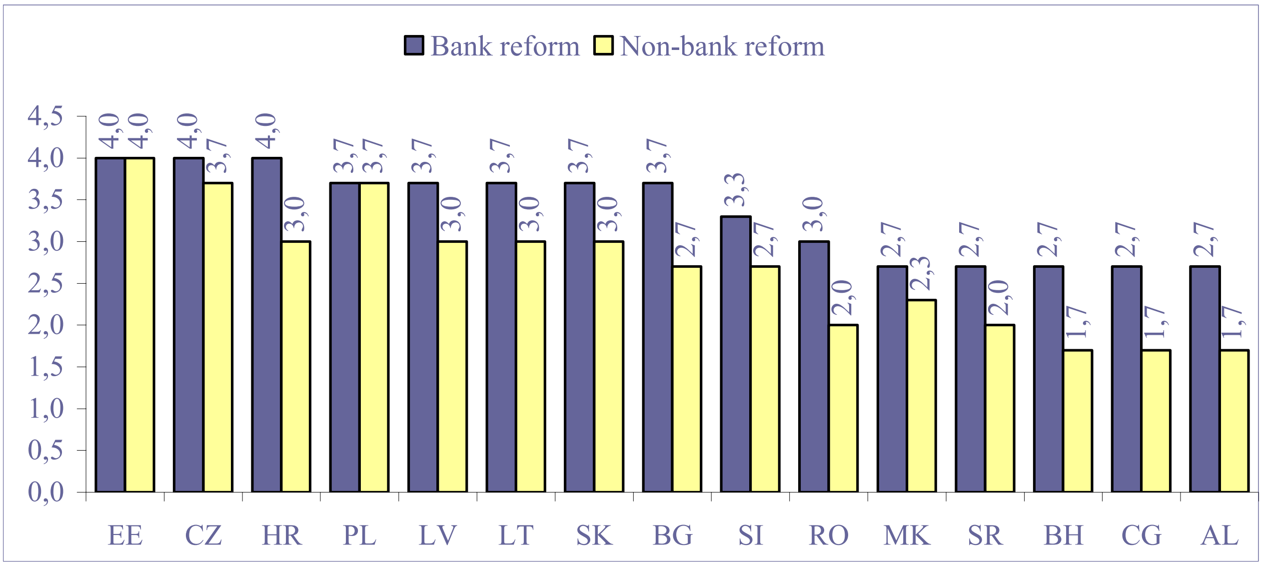
Graph 2. Size of non-bank financial sectors, 2005
(in percent of total financial sector assets)



Sources: ECB (2006a and 2006b); central banks.

The non-bank financial sector in the region is not only smaller, but is also institutionally less developed than the banking sector. The average EBRD score for transition in the non-bank sector is 2.7 (on a scale from 1 to 4), compared with 3.4 for reforms implemented in the banking sector (Graph 3). In the eight new member states that joined EU in 2004 the difference is smaller (3.3 for non-banks vs. 3.7 for banks); in south-eastern Europe it is larger (2.1 for non-banks vs. 3.0 for banks). The scores for the non-bank sector are the second lowest among EBRD transition indicators (after competition policy), indicating that there is considerable scope for further institutional improvement in this sector.

Graph 3. EBRD transition indicators of bank and non-bank reform, 2006



Source: EBRD.

Turning to the banking sector, its main characteristics in CEE are relatively small size, dominant position of foreign-owned banks, and a high degree of market concentration. In terms of GDP, total banking sector assets and private sector credit are on average less than half the size of those in the euro area (Table 2). Foreign-owned banks accounted on average for nearly 70% of total banking sector assets in CEE in 2005, compared with 24% in the euro area; private domestic banks for 22% (vs. 74% in the euro area); and state-owned banks for 9% (vs. 2%). State-owned banks remain relatively important only in Poland, Serbia, Slovenia and Turkey. The share of top five banks in total banking sector assets in CEE ranged from 49–83%, which is in most cases much higher than the average for the euro area (54%).

Regarding composition of commercial bank loans, there is considerable diversity among countries in the region. Starting from a highly distorted structure of lending in the late 1990s, when two-thirds of loans on average were extended to enterprises, 20% to the government and only 15% to households, by 2005 the structure of lending has clearly shifted in favour of households (Graph 4). Yet only in Croatia has the composition of loans evolved closer to that found in the euro area, with household loans representing one-half of total loans.

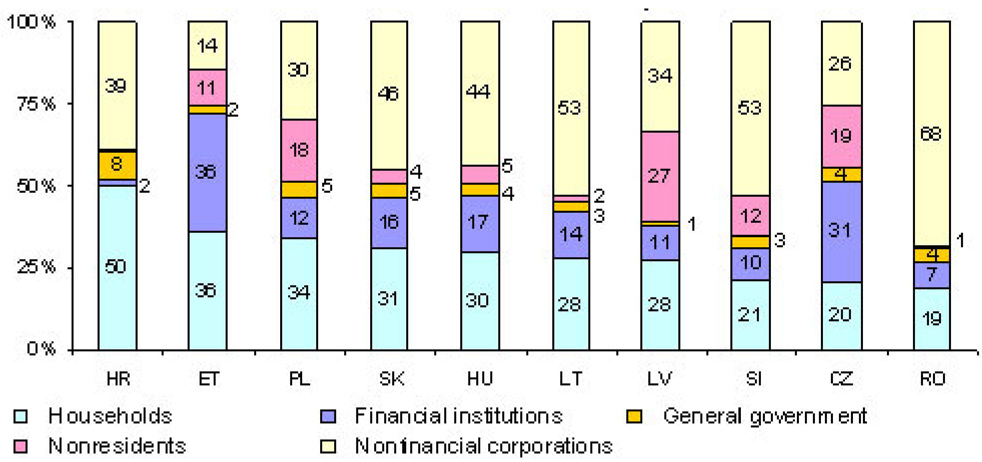
Another sign of limited progress in bank reform is the large discrepancy between private sector credit and household deposits, in countries as varied as the Czech Republic, Slovakia, Albania and Turkey. This discrepancy – amounting to 24% of GDP in the Czech Republic and 27% of GDP in Albania – suggests that commercial banks might not intermediate the available resources particularly efficiently. Furthermore, in the Czech Republic (as well as Estonia) commercial banks are directing half of total credit to other financial institutions (which are virtually all foreign-owned) and non-residents, leaving only half of bank loans for local enterprises and households.

Table 2. Structure of the commercial banking sector, 2005

Countries	Number of banks	Market share[2]				Ratio to GDP[2]		
		Foreign-owned banks	Private domestic banks	State-owned banks	Top five banks	Total assets	Private sector credit[3]	House-hold deposits[4]
Czech Rep.	35	96	1	3	65	121	40	64
Hungary	35	83	10	7	53	109	56	40
Poland	54	67	14	19	49	88	33	39
Slovakia	23	93	6	1	68	114	39	54
Slovenia	25	19	68	13	63	131	69	51
Bulgaria	34	80	18	2	51	91	47	39
Croatia	34	91	6	3	74	144	68	60
Romania	33	62	32	6	60	53	27	24
Albania	16	94	3	3	83	62	20	47
Bosnia-Herz.	33	81	15	4	64	98	54	41
Macedonia	20	53	45	2	68	63	30	30
Serbia	40	66	10	24	50	58	30	20
Turkey	47	6	59	35	63	103	30	48
Total/Average[5]	**429**	**69**	**22**	**9**	**62**	**95**	**42**	**43**
Euro area	*2,287*	*24*	*74*	*2*	*54*	*206*	*100*	*73*

1 Percentage of total assets. 2 In percent. 3 Excluding lending to non-monetary financial institutions. Data for 2006. 4 Data for 2004. 5 Total (first column) and unweighted average (remaining columns).
Sources: ECB; Bank Austria Creditanstalt; national data; author's estimates.

Graph 4. Composition of commercial banks loans, end-2005
Percent of total loans outstanding



Source: IMF, Financial soundness indicators database.

Prudential and profitability indicators show that banking systems in the region are generally well capitalised, profitable and have a robust asset quality (Table 3). Reflecting balance sheet restructuring and better risk management, the share of non-performing loans was reduced more than three times in the past six years, from 16.5% in 1999 to 5% in 2005. Banks maintained a high capital adequacy ratio (15.8% on average in 2005) and their provisioning against loan losses increased to 65% of non-performing loans over this period. Likewise, profitability improved to a level higher than or comparable to that in countries such as Austria: whereas in 1999 commercial banks in central and eastern Europe were on average loss-making, by 2005 the return on equity increased to over 16% on average, and the return on assets to 1.3% on average, compared with 9.3% and 1.5%, respectively, in Austria.

Table 3. Prudential indicators and commercial bank profitability

Countries[1]	Non-performing loans[2]		Capital adequacy[3]		Loan-loss provisions[4]		Return on equity		Return on assets	
	1999	2005[9]	1999	2005[9]	2000	2004	1999	2005[9]	1999	2005[9]
Estonia	1.7	0.2	16.1	12.9	…	…	9.2	19.4	1.4	2.0
Czech Rep.	22.0	2.8	13.6	11.6	46.8	69.4	–4.3	32.1	–0.3	1.7
Lithuania	12.5	0.6	17.4	9.8	34.6	21.6	1.1	16.0	0.5	1.3
Slovakia	23.7	5.0	29.5	12.3	75.1	89.1	–36.5	13.7	–2.3	1.1
Croatia	11.8	6.2	20.6	14.7	79.9	58.0	4.8	20.2	0.7	1.6
Bulgaria	29.0	2.2	43.0	15.2	65.9	49.2	20.9	17.0	2.5	1.8
Hungary	3.6	2.2	14.9	12.3	57.0	51.1	7.1	29.8	0.6	2.3
Poland	13.2	4.8	13.2	14.6	40.5	58.0	12.9	20.6	0.9	1.6
Bosnia-Herzeg.[5]	9.9	3.5	26.3	18.0	64.2	96.1	–5.8	5.6	–1.3	0.6
Romania	35.4	2.6	17.9	21.1	85.7	55.1	–15.3	14.9	–1.5	1.9
Latvia	6.0	0.5	16.0	10.0	74.1	99.1	11.2	25.1	1.0	2.1
Macedonia	41.3	13.2	28.7	23.0	…	76.2	3.5	6.2	0.8	1.1
Serbia-Monten.[6]	21.6	22.8	25.6	27.9	…	…	–60.6	–5.3	–8.4	–1.2
Slovenia	5.2	3.0	14.0	9.7	45.3	34.0	7.8	17.0	0.8	1.1
Turkey	10.5	5.4	8.2	23.3	63.1	89.6	33.1	8.6	3.3	1.1
Average	**16.5**	**5.0**	**20.3**	**15.8**	**61.0**	**65.1**	**–0.7**	**16.1**	**–0.1**	**1.3**
High share of foreign banks[7]	14.9	2.7	22.2	12.7	59.9	56.4	0.3	21.2	0.4	1.7
Lower share of foreign banks[8]	17.9	7.0	18.7	18.4	62.2	72.6	–1.7	11.6	–0.6	1.0
Memo: Austria	*1.7*	*1.5*	*13.9*	*14.7*	…	…	*6.9*	*9.3*	*0.3*	*1.5*

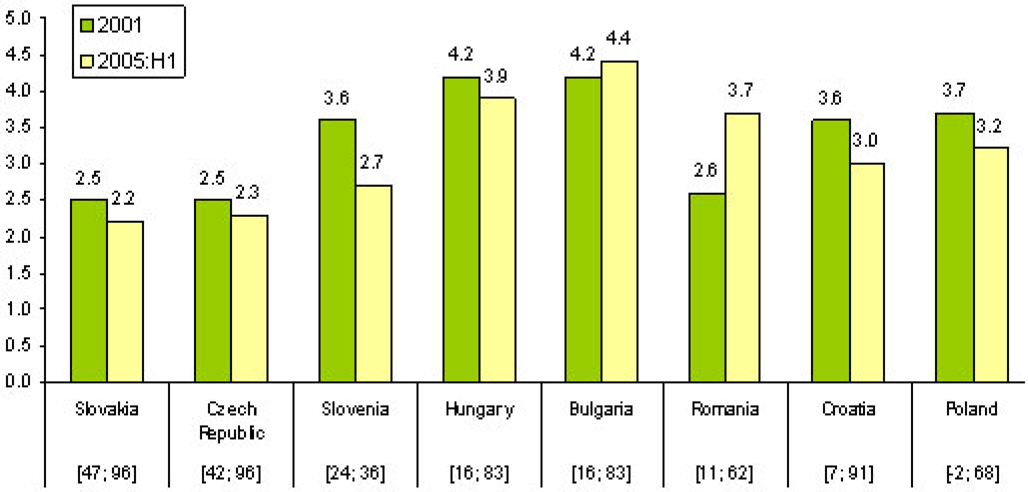
1 Ordered according to the share of foreign-owned banks in total banking sector assets (from 80–99% in Estonia, the Czech Republic, Lithuania, Slovakia, Croatia, Bulgaria and Hungary; below 70% in other countries). 2 As percent of total loans. 3 Risk-weighted capital-asset ratios, in percent. 4 Ratio of bank provisions for loan losses to non-performing loans, in percent. 5 End-2000 instead of 1999. 6 End-2002 instead of 1999. 7 Average for the countries with a share of foreign bank ownership higher than or equal to 70% of total banking sector assets. 8 Average for the countries with a share of foreign bank ownership lower than 70% of total banking sector assets. 9 For some countries, data refer to 2004.
Sources: Central banks; IMF; author's estimates.

Foreign-owned banks have played a major role in these improvements (see Mihaljek, 2007). As indicated in the lower part of Table 3, in countries where foreign-owned banks account for more than 70% of total banking sector assets, non-performing loans were reduced by a larger proportion (about 12 percentage points) and to a much lower level (2.7% in 20045 than in countries with a lower share of foreign bank ownership. In countries with a higher share of foreign ownership bank capital is used more efficiently and banks generate considerably higher return on equity. Where foreign ownership is higher, banks also increased profitability by a much larger margin between 1999 and 2005.

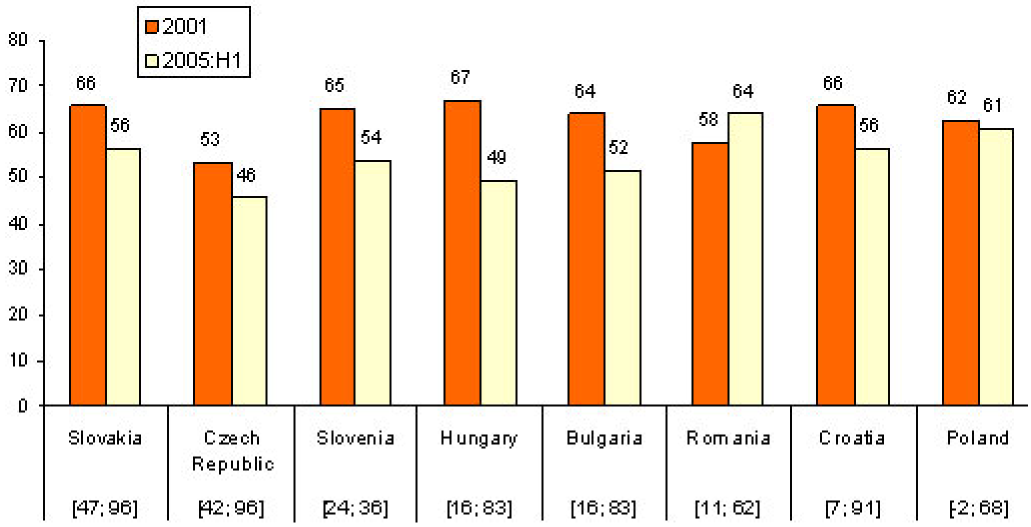
A similar picture emerges when indicators of bank efficiency such as net interest income and operating costs are considered. In Graph 5, countries are ordered in terms of the percentage increase in the share of foreign-owned banks in total banking sector assets between 2000 and 2004. The more the countries increased this share, the more they tended to reduce operating costs and diversify the sources of their income away from net interest income.

One should note that some of the improvement in prudential and efficiency indicators may reflect cyclical factors. Many loans extended during the recent period of rapid credit growth have yet to mature, so the non-performing loan ratios recorded at the end of 2005 may not fully reflect the quality of banks' loan portfolios. Part of the improvement in non-performing loan ratios also reflects the fact that many banks (especially the former state-owned banks that were sold to foreign strategic investors) unloaded a significant portion of their non-performing loan portfolios to asset management companies and other vehicles for resolution of bank distress.

Graph 5. Net interest income
As percentage of annual bank assets



Operating costs
As percentage of current operating income



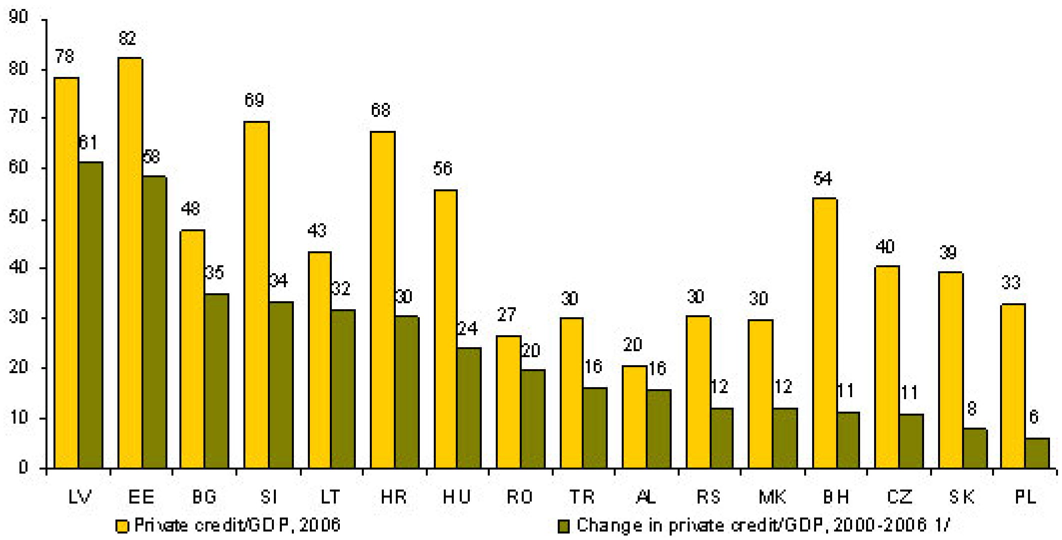
Note: Countries are ordered in terms of the percentage increase in the share of foreign-owned banks sector assets between the end of 2000and the end of 2004, as indicated by the first figure in brackets below the name of the country (the second figure denotes the foreign banks share at the end of 2004)
Sources: Mihaljek (2006b) based on Bank Austria Creditanstalt an national data.

Moreover, **private domestic banks** in several countries have outperformed foreign-owned banks in terms of prudential indicators. Data available for Hungary, Poland and Turkey indicate, for instance, that private domestic banks had improved prudential indicators to a greater extent and often to a higher level than foreign-owned banks between 1999 and 2004 (see Mihaljek, 2006). This is a major achievement considering that in many countries private domestic banks had to cope with restructuring at their own shareholders' expense, whereas the state-owned banks were typically restructured at taxpayers' expense and subsequently sold to foreign-owned banks, in most cases below the cost of restructuring.

2. Developments in the banking sector

Many of the central and eastern European countries are currently in the seventh year of strong expansion of bank credit to the private sector. **Financial deepening**, as measured by the ratio of credit to GDP, has progressed considerably as a result of these developments. Between 2000 and 2006, private sector credit expanded by 24% of GDP on average – in the case of Estonia and Latvia by as much as 60% of GDP, bringing their credit to GDP level to around 80% last year (Graph 6). In Bulgaria, Croatia, Lithuania and Slovenia, these ratios also increased by 4–5% of GDP for seven years in a row, thus approaching a common benchmark of 5% of GDP per year often used to assess whether credit growth has become "excessive".

Graph 6. Financial deepening in central and eastern Europe, 2000-2006



1/ For the Czech Republic, Serbia and Turkey, 2002-2006; Slovakia, 2003-2006.
Sources: IMF, International Financial Statistics and WEO; national data.

As noted above, credit to GDP ratios in the region – including in the larger and more developed economies such as the Czech Republic, Poland and Slovakia – are arguably still low compared to the euro area average (around 100%). This indicates that there is substantial scope for further financial deepening and hence for further credit growth. Portugal went through a similar process of rapid deepening: starting from a private sector credit-to-GDP ratio slightly above 40% in 1990, it caught up with the euro area average (at the time around 80%) by 1997.

Loans to the households, in particular housing loans, have played a key role in the expansion of private sector credit in the past few years. As shown in Table 4, housing loans expanded on average by 56% per annum and contributed 42% to the growth of total private sector credit during 2003–05. The contribution of household loans – and housing loans in particular – was larger than or equal to that of corporate loans in all countries considered, with the exception of Lithuania and Slovenia. Within household loans, consumer loans made a larger contribution to the growth of private sector credit only in Bulgaria and Croatia. One should note that in many countries (including the Baltic states, Romania and, until recently, Croatia) a significant part of credit to the households is provided by leasing companies, which are often owned by commercial banks but are not included in banking sector statistics. The above figures thus underestimate to some extent the extent of credit expansion. In Estonia, for instance, credit provided to the private sector by bank-owned leasing companies amounted to 15.4% of GDP in 2004.

Growth in corporate loans has remained more modest. Over the past two years it ranged from 5–15% per year in Bulgaria, Croatia and central Europe (except Slovenia); to 30–60% per year in the Baltic states, Romania and Slovenia. One reason for the slower growth of **corporate loans** in central Europe is that corporate earnings have strengthened and firms have accumulated large liquid funds that enable them to finance production and investment without recourse to bank credit. Many firms have also gained direct access to international capital markets or to inter-company loans from foreign partner companies (discussed below).

Table 4. Housing loans and private sector credit growth, 2003–05

Countries	Growth of private sector credit[1]				Contribution to growth of private sector credit[2]			
	Corporate	Household			Corporate	Household		
		Total	Housing	Consumer		Total	Housing	Consumer
Bulgaria	28.7	63.3	114.8	51.5	50.5	49.5	17.3	32.1
Croatia	8.4	16.7	23.3	13.7	22.4	62.7	24.9	37.9
Czech Republic	11.1	32.3	39.6	23.3	10.7	89.3	69.9	19.4
Estonia	40.7	56.8	64.2	34.2	45.4	54.6	47.5	7.0
Hungary	12.3	28.5	26.1	44.2	40.8	59.2	43.9	15.8
Latvia	16.4	53.2	60.0	42.4	43.0	57.0	35.5	6.4
Lithuania	27.6	67.1	68.9	3.3	59.0	41.0	40.7	0.3
Romania	30.8	64.8	67.8	42.9	50.7	49.3	46.1	3.2
Serbia	25.2	61.4	…	…	48.4	51.6	…	…
Slovakia	3.7	35.4	34.9	15.6	27.0	73.0	51.7	15.2
Slovenia	40.0	105.	…	…	78.0	22.0	…	…
Average	**22.3**	**53.1**	**55.5**	**30.1**	**43.3**	**55.4**	**41.9**	**15.3**

1 Annual growth rate of private sector credit (excluding credit to financial intermediaries), 2003–05; in percent. Data for 2005 are for the latest month available. 2 Percentage contribution to the annual growth rate of private sector credit; average for 2003–05 (for Slovakia, 2004–05). Based on monthly data.

Sources: Central banks; author's estimates.

In south-eastern Europe, growth of corporate credit has been in addition constrained by the slow development of **market infrastructure**, including corporate bankruptcy procedures; credit bureaus; corporate and collateral registries; and use of international standards for financial reporting and auditing. These weaknesses have made information about corporate borrowers (especially small and medium-sized enterprises) opaque and banks unable to make informed credit decisions.

Another significant development has been rapid growth of **foreign currency loans**, in particular to households. In just two years, the share of foreign currency loans increased on average by 10 percentage points, to 46% of total household loans (Table 5). Several countries have seen foreign currency loans expanding at triple-digit rates during this period. Foreign currency loans are currently unimportant only in the Czech Republic; elsewhere they account for about 10–40% of total private sector credit.

The main **motivation for taking foreign currency loans** is the lower interest rate: in 2006, the average interest rate differential between long-term loans to households in foreign and domestic currencies was about 2¾ percentage points, ranging from 0.2 points in Lithuania to 6½ points in Estonia (Table 5). Moreover, many currencies in the region have been appreciating in nominal terms against the euro due to capital inflows and Balassa-Samuelson effects. Other reasons for the widespread use of foreign currency loans include close currency pegs, historically low exchange rate volatility, lack of risk awareness and herd behaviour (see ECB, 2006a).

Table 5. Foreign currency loans to households by banks in central and eastern Europe

Country	Share of FX loans to households (%)			Growth rate of FX loans to households (% per year)		Interest rate differential IR on FX loans vs. IR on domestic currency loans (percentage points)	
	In total household loans		In private sector credit				
	2004	2006	2006	2005	2006	2004	2006
Bulgaria	9	17	7	122.0	77.9	–4.2	–2.0
Croatia[1]	81	77	40	31.3	–2.7	–5.0	–5.2
Czech Republic	0	0	0	9.1	–20.7	–2.0	–0.5
Estonia	65	78	39	96.6	89.0	–1.1	–6.5
Hungary	6	40	14	191.4	134.1	–6.3	–4.5
Latvia	62	73	34	97.4	85.2	–1.9	–1.0
Lithuania	36	49	19	138.7	67.0	–0.8	–0.2
Poland	31	39	9	53.0	54.6	–3.0	–0.9
Romania	44	40	18	72.2	47.0	–16.6	–4.9
Slovakia	…	…	…	…	…	–3.9	–2.9
Slovenia	23	42	9	107.9	40.1	0.3	–1.0
Average	**36**	**46**	**19**	**92.0**	**57.2**	**–4.0**	**–2.7**

[1] Includes domestic currency loans with interest rate linked to the exchange rate
Sources: Central banks; author's estimates.

The growth of foreign currency loans has been accompanied by the expansion of **cross-border flows to banks in CEE**. Until the euro changeover in 2002, the growth of local deposits was sufficient to finance credit expansion from domestic sources. Since then, foreign bank subsidiaries have financed a significant part of credit expansion in the region by borrowing from their headquarters. The consolidated claims of BIS reporting banks vis-à-vis banks in CEE (including local claims in foreign currencies) expanded by $20 billion in 2004 and 2005; in the first half of 2006 alone, these claims increased by $17 billion (Table 6). The amounts involved – up to 13% of GDP in 2006 – clearly represent a source of external vulnerability for countries such as Croatia, Estonia and Latvia, especially in view of the already large outstanding stocks of such claims, which ranged from 19% to 50% of GDP in these countries.

Although financial systems of CEE countries are bank-based, the scale of total credit growth would be seriously underestimated if one looked only at the banking sector data. Direct **cross-border credit to the non-bank private sector** in the region is substantial: in 2004, these flows amounted to $28 billion; in 2005 they doubled to $55 billion; reaching $42 billion in the first half of 2006 alone (Table 7). These flows represent substantial amounts in macroeconomic terms, about 8% of GDP on average in 2005, and up to 15–18% of GDP in several countries. The stocks of outstanding international claims vis-à-vis the private sector amounted to 70% of GDP in Estonia and 30–40% of GDP in Croatia, Latvia and Lithuania.

As noted above, a significant part of direct cross-border credit to households is provided to by way of leasing companies. Since these companies are typically owned by commercial banks, when the authorities tighten prudential regulations for banks one can often observe an increase in credit provided by the non-banks. Regarding cross-border credit provided to corporations, large internationally active companies in particular often get cheaper funding abroad or may have simply become too large to get adequate financial services and sufficient funding from local banks.

These statistics still do not fully capture the scale of cross-border credit in central and eastern Europe. As noted above, the **cross-border intra-company credit** – usually supplier and trade credit – is sizable in many countries, including credit to small and medium-sized enterprises that are getting closely integrated into western European production networks.

Table 6. Growth of international claims vis-à-vis the banks in CEE[1]
Changes in amounts outstanding at end-period

Country	In millions of USD			In percent of GDP		
	2004	2005	2006:H1	2004	2005	2006[2]
Czech Republic	14	781	2,066	0.0	0.6	1.5
Hungary	4,384	–1,655	883	4.3	–1.5	0.9
Poland	–201	414	1,267	–0.1	0.1	0.4
Slovakia	922	514	–536	2.2	1.1	–1.0
Slovenia	1,093	1,608	1,423	3.4	4.7	4.1
Estonia	2,117	2,617	2,000	18.9	20.0	13.2
Latvia	1,350	2,677	1,421	9.8	16.9	7.4
Lithuania	740	1,542	–245	3.3	6.0	–0.9
Bulgaria	464	595	469	1.9	2.2	1.7
Croatia	1,082	411	4,953	3.1	1.1	11.6
Romania	1,552	2,800	2,103	2.1	2.8	1.9
Turkey	6,691	6,911	183	2.2	1.9	0.0
Albania	12	36	27	0.2	0.4	0.3
Bosnia-Herzegovina	115	201	22	1.3	2.2	0.2
Macedonia	–10	22	–13	–0.2	0.4	–0.2
Serbia-Montenegro	523	601	1,256	2.3	2.5	4.6
Total / Average	**20,848**	**20,075**	**17,279**	**3.4**	**3.8**	**2.9**

1 Consolidated claims of BIS reporting banks (immediate borrower basis); in all currencies and local claims in non-local currencies. 2 Projection, assuming 2006:H2 levels are the same as in 2006:H1; September 2006 WEO forecasts of GDP.

Table 7. Growth of international claims vis-à-vis the non-bank private sector in CEE1
Changes in amounts outstanding at end-period

Country	In millions of USD			In percent of GDP		
	2004	2005	2006:H1	2004	2005	2006[2]
Czech Republic	1,743	4,854	1,930	1.6	3.9	1.4
Hungary	6,158	7,676	3,441	6.1	7.0	3.3
Poland	3,910	6,741	6,290	1.5	2.2	1.9
Slovakia	525	2,509	1,177	1.2	5.3	2.2
Slovenia	695	3,065	836	2.1	9.0	2.4
Estonia	1,998	1,746	3,796	17.8	13.3	25.1
Latvia	994	2,595	3,411	7.2	16.4	17.8
Lithuania	2,113	2,799	2,226	9.4	11.0	7.7
Bulgaria	1,473	2,164	2,272	6.1	8.1	8.0
Croatia	1,336	6,915	1,414	3.8	18.0	3.3
Romania	2,982	3,856	3,798	4.0	3.9	3.4
Turkey	2,960	6,544	10,323	1.0	1.8	2.7
Albania	88	62	12	1.2	0.7	0.1
Bosnia-Herzegovina	306	1,397	84	3.6	15.0	0.8
Macedonia	70	16	93	1.3	0.3	1.6
Serbia-Montenegro	417	2,534	1,432	1.9	10.5	5.2
Total / Average	**27,768**	**55,473**	**42,535**	**4.4**	**7.9**	**5.4**

Consolidated claims of BIS reporting banks (immediate borrower basis); in all currencies and local claims in non-local currencies. 2 Projection, assuming 2006:H2 levels are the same as in 2006:H1; September 2006 WEO forecasts of GDP. Sources: BIS; IMF; author's estimates.

3. DETERMINANTS OF CREDIT GROWTH AND POTENTIAL VULNERABILITIES

Credit growth in C has been driven by a combination of macro- and microeconomic factors affecting both credit demand and supply. The **demand for credit** has grown because of increases in disposable income, rising income expectations, higher confidence (partly related to EU accession), falling inflation and interest rates, a stable or appreciating trend of local currencies (encouraging foreign currency borrowing) and better investment opportunities.

The increased **supply of bank loans** has been driven primarily by financial sector deepening and deregulation described above. In particular, large privatisations in the banking sector and public sector retrenchment from banking had a large impact on bank's lending capacity. Increased competition among banks (as a result of foreign entry into the market to capture market share) has led to narrowing margins and higher credit growth to maintain profitability (Mihaljek, 2006). In some countries (Estonia and especially Hungary before 2004), housing subsidies have also contributed to credit growth.

Against this background, several recent studies examine the speed of credit growth in CEE countries in a more detailed analytical framework, seeking to estimate **"equilibrium" rates of credit growth** based on selected economic fundamentals.[27] One finding of these studies on which there seems to be some agreement is that one cannot exclude the existence of a household credit boom for Estonia, Latvia and Hungary, with Croatia and Bulgaria following not far behind. These countries' credit to GDP ratios are already within the estimated "equilibrium range" but credit growth remains very high. The risk of having household credit booms in Estonia and Hungary would increase if credit extended by non-bank financial institutions was taken into account. In

[27] See eg Arcalean et al (2007); Backé et al (2007), Boissay et al (2006), Coricelli et al (2006), ECB (2006c), Enoch and Otker-Robe (2007); IMF (2006a and 2006b), Kiss et al (2006) and World Bank (2007).

Lithuania and Slovenia, the observed credit growth could in general be explained by fundamentals and convergence factors. In the Czech Republic, Poland and Slovakia no signs of excessive credit growth were detected. Research in this area is continuing.

One major impediment to an objective assessment of what constitutes "equilibrium" path of credit growth is the lack of adequate data. In several CEE countries there are problems in measuring the sectoral and currency composition of bank lending. Coverage of non-bank lending is weak throughout the region. There are also considerable difficulties in tracking real estate developments, in particular residential and commercial property prices.

Regarding **potential vulnerabilities** associated with rapid credit growth, the current prevailing view seems to be that the rapid credit growth in central and eastern Europe has so far been mostly a benign phenomenon (ECB, 2006c; Enoch and Otker-Robe, 2007; IMF, 2006a and 2006b; World Bank, 2007). Businesses and consumers have greatly benefited from the lifting of credit constraints and improved access to a wide range of financial products. This has enabled firms to engage in productive investment and households to smooth consumption, resulting in turn in rapid economic growth and convergence of living standards with those in EU-15. Recently, however, the credit expansion has been so pronounced in so many countries at the same time that uncertainties about its "normal" pace have emerged. Most central banks in the region have therefore taken a cautious approach and have started to monitor closely various vulnerabilities that the credit growth might entail.

The main **macroeconomic vulnerabilities** include the widening of external current account deficits and rising external indebtedness; rising inflation; exchange rate pressure; and the risk of reversals in capital flows. These vulnerabilities have already materialised to different degrees: the Baltic states and countries in south-eastern Europe have large and persistent current account deficits; private sector external debt in the Baltic states and Croatia is rising fast; and inflation in several euro-candidate countries has accelerated partly as a result of domestic demand pressures.

One of the main **financial sector vulnerabilities** would seem to be banks' exposure to credit and currency risks via housing loans and foreign currency loans to unhedged borrowers, and the associated risk of currency mismatches on aggregate private sector balance sheets. As noted above, banking systems in the region are generally sound. The results of stress tests conducted by the authorities and assessed by international financial institutions generally indicate that, at least in the new member states, the banking sector as a whole appears to be resilient to macroeconomic and prudential shocks, although some individual banks show greater sensitivity to specific shocks (IMF, 2006b; World Bank 2007). The stress tests, developed partly in the context of Financial Stability Assessment Programmes of the IMF and the World Bank, involve credit, interest rate, exchange rate and contagion shocks, individually or jointly under broader scenarios, expressing the effect as a percentage of bank capital adequacy, assets or profitability.[28]

As these vulnerabilities are already closely monitored by country authorities, financial markets and international financial institutions, in this paper I shall focus on the **risk of foreign currency lending**, which has attracted particular attention of policymakers over the past year. The assessment of vulnerabilities arising from foreign currency lending involves a range of financial stability issues affecting household and corporate sectors as well as banks and other financial institutions (see ECB, 2006a).

In addition to being attractive to borrowers, foreign currency lending is also attractive to **foreign-owned commercial banks** operating in central and eastern Europe. The cost of funding in international capital markets has been very low in recent years. Given abundant liquidity in parent institutions and the relatively small size of CEE markets, there have been few limits to such funding. While this situation might be sustainable for individual banks, the growth of foreign liabilities gives rise to external vulnerabilities, in particular in those countries that will not join the euro area in the medium term. At some point, excessive growth of private external debt might signal increased external vulnerability and put pressure on the currency.

Perceptions of admission to EMU being all but assured may have also reduced concerns about exchange rate risk, both on the side of borrowers and lenders. As a result of substantial losses in earlier developing country

[28] Because of financial stability concerns, not all central banks make these results available to the public, but some conclusions may be found in their Financial Stability Reports. For an overview of the reported results see World Bank (2007).

crises, many foreign-owned banks offered for some time in the 1990s only loans in local currency. However, once EU accession and the prospect of euro adoption were on track, foreign banks' concerns about currency mismatches have diminished and they started to expand foreign currency loans. Hard peg countries – the Baltic states, Bulgaria and Bosnia and Herzegovina – illustrate how this can accelerate financial deepening. A case such as Romania confirms that perceptions of trend appreciation may have analogous effects. The rise in foreign currency borrowing, although not always justified by risk analysis, thus partly reflects expectations of entry to the euro area before many longer-term loans (such as mortgages) mature.

Commercial banks' open foreign currency positions are limited by prudential regulations. However, to the extent that borrowers do not earn foreign currency income, commercial banks would remain exposed to foreign exchange risk in the form of **credit risk**. For instance, banks in Hungary and Poland held on their balance sheets in 2005 a significantly higher proportion of foreign currency assets than foreign currency liabilities: 23% vs. 16% in Poland; 38% vs 32% in Hungary. However, a growing proportion of these assets in recent years might have been foreign currency loans to unhedged borrowers.

On the **corporate side**, cross-border credit and local foreign currency credit is often hedged through export receipts. Given the very high export shares – up to 80% of GDP in central Europe and the Baltics – many business borrowers are hedged naturally. But limited survey data indicate that this is not always the case. In Hungary, for instance, a recent central bank survey indicated that firms without foreign currency income accounted for about half of the foreign currency debt of small and medium-sized enterprises in 2005 (see Bodnar, 2007).

On the **household side**, foreign currency borrowing is often hedged by holding foreign currency assets. Households in south-eastern Europe in particular have traditionally held their savings in the form of foreign currency deposits. However, these holdings often have not kept pace with the growth of liabilities.

A large **currency mismatch** might thus arise on the aggregate private sector balance sheet if local currencies suddenly weakened. A recent stress test by the National Bank of Hungary (2006) showed for instance that a 20% forint depreciation with a 6 percentage point rise in domestic interest rate would increase the average debt burden for total outstanding household loans by 10%. Some banks have announced that in such event they would prolong the maturity of foreign currency loans to CEE customers. Given that exposure to the region via such loans is relatively small compared to consolidated assets of large European banks, this approach might be feasible. But the precedent it sets for financial discipline and its moral hazard implications should not be overlooked.

Moreover, foreign currency lending to unhedged borrowers entails **reputation costs for banks**. Borrowers, especially households and small enterprises that incur large losses when their collateral is to be liquidated, might argue that they had not been informed sufficiently well about the actual risks of foreign currency loans and may thus claim damages from banks. Authorities of countries with high levels of foreign currency loans and rather flexible exchange rate regimes see at least some danger for the reputation of banks, with potentially adverse effects on their global franchise values (ECB, 2006b).

In summary, despite signs of some vulnerabilities associated with rapid credit growth in general, and foreign currency lending in particular, emerging in different countries, financial systems in the CEE economies on the whole seem stable and sound. Sources of vulnerability in the corporate and household sectors are in most cases country-specific and no generalisations could easily be made. Nonetheless, if corporations, households and banks are forced to restructure their balance sheets after a rapid build-up of debt, one should not underestimate the risk of a prolonged period of slow growth in the affected countries.

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PÉTER BILEK: BULGARIA AND ROMANIA: ROAD TO EURO

INTRODUCTION

Bulgaria and Romania joined the European Union at the beginning of 2007. Accordingly, all Central and Eastern European transition countries which signed the European Agreement in the first half of 1990s, applied for EU membership and started the accession negotiations before the end of the last millennium, entered into the EU.

In the second part of the 1990s the aforementioned transition countries divided into two groups. The first group included the Czech Republic, Estonia, Hungary, Poland and Slovenia (so-called Luxembourg group), while the second group was consisted of Bulgaria, Latvia, Lithuania, Romania and Slovakia (Helsinki group). The negotiation started earlier with the members of the first group (in 1998), while it launched 1-2 years later in case of the second group of countries. However, not five but eight transition countries acceded to the EU in May 2004 due to that the two Baltic states and Slovakia eliminated the lag and joined the "front-runners' club". On the other hand, the two Southeast European countries, namely Bulgaria and Romania failed to progress rapidly in European integration, accordingly their accession occurred almost three yeas later.

The main reason why Bulgaria and Romania could not join the EU in 2004 was that the negotiations progressed quite slowly compared to the other countries. In November 2001 Hungary had 23 provisionally closed chapters and the laggard Poland also had 19 chapters, while the corresponding number of Bulgaria and Romania were only 13 and 9, respectively.

Structural reforms progressed slowly in comparison with the front-runner transition countries, which resulted in the slower evolution of the accession negotiations as well. It is well reflected in the fact that Romania was considered as a functioning market economy only in the 2004 Progress Report, which was important to fulfil the Copenhagen criteria.

The delay of the reforms meant that stabilisation, liberalisation and privatisation occurred later compared to most CEE countries. It is obvious that Romania had the hardest situation to solve at the beginning of transition since the standard of living was the lowest in Romania among the CEE countries. Accordingly, the new government tried to ease the burden of the population during the first period of the transition, accordingly, the restructuring process developed slowly. Economic growth returned in mid-1990 (more than 7% growth in 1995), which was due to the development of the export sector, however, the delay of structural reforms has not allowed to get on a sustainable economic growth path, and the growth turned to recession again in the second half of the last decade. In 1997 the government finally implemented stabilisation measures based on the speed-up of privatisation process, price liberalisation and the incentive of foreign direct investments. Besides, the country switched to a floating exchange rate regime.

The delay of the reforms and the second recession period were partly the reasons for that the two newly acceded countries' are significantly poorer in comparison with not only the old members but also the countries, which joined the EU in 2004. In 2006 GDP per capita (PPS) in Bulgaria and Romania reached only 36.5% and 37.4% of EU average, respectively. Poland, which was the poorest EU country in this respect before the accession of the two countries, reached 53.4% in 2006, which reflects well the large gap between the two groups of countries.

If one considers the gaps on regional level (NUTS II) then the difference is even larger. The Northeast region of Romania became the poorest region in the EU with its 23.6% (in 2004), which is quite low especially in comparison with the richest region of EU (Inner London, 302%). The 11 poorest regions of the enlarged EU are located in the two newly acceded countries.

The richest new region is Bucharest, which reached 64.5% of EU average in 2004, while the second highest GDP per capita figure was observable in the Southwest region of Bulgaria, which includes Sofia. The highest convergences to EU average between 2000 and 2004 occurred in Southwest Bulgaria (8.2 percentage points), West Romania (12.1 percentage points) and Bucharest (10.5 percentage points).

ADVANTAGES AND COSTS OF EURO

The accession to the European Union for the Central and Eastern European countries has meant the obligation to join the euro zone as well. Accordingly, to join the euro zone these countries need to fulfil the Maastricht criteria. The questions are basically that when and how these countries will be able to fulfil the criteria and introduce the single European currency.

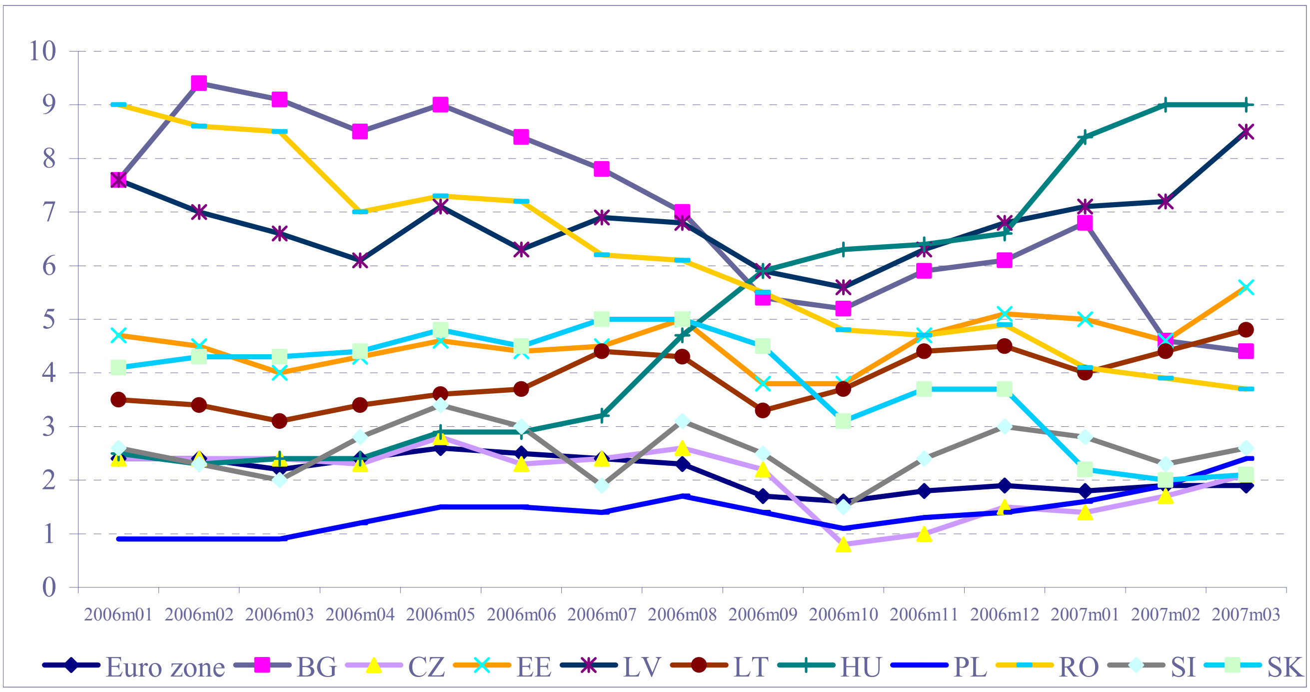
Before analysing the lessons of the countries, which joined the EU in 2004 it is important to see what the main advantages and costs of the adoption of euro are. The main advantage of introducing the single European currency is the elimination of costs and risks related to national currency. Since there is no national currency, accordingly there are no exchange rate risk and volatility. In line with that, trading relationship strengthens, business climate become more favourable, interest rates decrease and financial system deepens and integrates into the European market owing to the adoption of the single currency. Besides, introduction of euro eliminates transaction costs and prices become comparable. It is also worth mentioning that the single currency has a positive impact on the macroeconomic policy as well.

On the other side, the most important "cost" of introducing euro is to give up national monetary policy, including exchange rate depreciation and interest rate setting. These measures are important in case of an asymmetric external shock, when pegged exchange rate is a problem since the shock has different impact on the country than on the anchor currency. Besides, another cost of the introduction of a new currency is related to the replacement of old bank notes and coins in the economy.

LESSONS OF THE COUNTRIES JOINED THE EU EARLIER

The advantages of entering into the euro zone in case of the CEE countries joined the EU are obvious. Large share of their trade is denominated in euro and most of these countries are small and open economies, the export of goods and services per GDP indicator exceeded 50% in 2006 in all CEE member states except for Latvia and Poland. It indicates that the adoption of the single European currency will have a significant positive impact on trade relation via reduction of transaction costs and elimination of exchange rate risks. In case of the two newly acceded countries these figures are lower but catching up is observable especially in Bulgaria.

Graph 1. 12-month inflation in selected CEE countries January 2006 - March 2007 (%)



Source: Eurostat

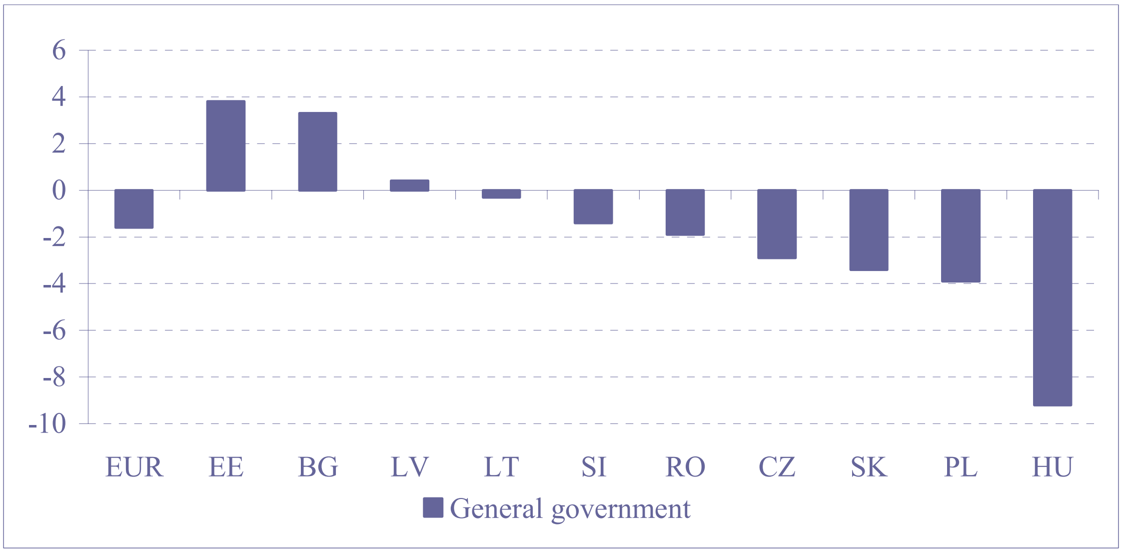
It is also worth mentioning that business climate will also improve thanks to entry into the euro zone, in line with the improving trade relations. The fact that euro will be the currency in these economies will attract more foreign direct investments in these economies. However, these countries are in competition to draw more and more foreign investments. Accordingly, not only the introduction but also its timing is important in this competition.

Therefore, the CEE member states planned ambitious target dates to join EMU right after their accession. Between May 2004 and November 2005 five out of the eight CEE member states entered into the ERM II regime, the exceptions were the Czech Republic, Hungary and Poland. According to the rule, those countries are allowed to introduce euro, which can fulfil Maastricht criteria for two consecutive years in ERM II regime. In last three years only Slovenia was able to fulfil these criteria.

In case of the Baltic states the reduction of inflation rate under the reference value was the key problem which hindered these countries' to introduce euro. After EU accession, target date to enter into the euro zone was 2007-08 in Estonia, Latvia and Lithuania, while recently these dates are postponed to 2011-2012. The postponement of the target dates was due to the inflationary pressure boosted by dynamic economic growth, robust growth of credit to households, significant increase of real wages and the development of energy prices, which increased inflation rate above the reference value and made the adoption of euro unachievable according to plans. Furthermore, it seems that inflation cannot be reduced to that level before 2009-10.

In case of the so-called Visegrad countries (the Czech Republic, Hungary, Poland and Slovakia) not the only but fiscal developments caused problems. While general government balances are in balance or have surplus in the Baltic states owing to the applied monetary policy (currency board arrangement and later the ERM II regime), in the Visegrad countries the reduction of budget balance under the Maastricht level represents the hardest problem. One of the most important problems is that there was no significant public finance reform to decrease public spending in these countries except for Slovakia. In Hungary one can observe that the government has made some steps on that road recently since budget deficit reached record high level and measures cannot be postponed. In the remaining two Visegrad countries the high economic growth helped these countries to postpone the necessary public finance reforms. On the other hand, in Slovakia budget deficit is expected to be decreased under 3% this year, while inflation rate is also low. Accordingly, Slovakia is expected to enter into the euro zone in 2009 and that country can be the second after Slovenia that will exchange its national currency to the single European currency, while the other three countries has not even joined ERM II regime yet. In case of the Czech Republic and Poland the adoption of euro is expected in around 2012, while a later date is expected in Hungary.

Graph 2. Budget balances in the selected CEE countries, 2006 (% of GDP)



Source: Eurostat

Besides lessons of the CEE countries, it is also worth mentioning another example, namely that of Portugal. Portugal has introduced euro in 1999 with 11 other member states since the country fulfilled the necessary conditions. However, the country lost its competitiveness, the economic growth decreased and accordingly the convergence process turned into divergence. The reason was that credit to households exploded in line with decreasing interest rates and increasing real wages especially in public sector. Besides, fiscal policy loosened as well and the base of economic growth shifted to domestic factors while the role of external demand diminished. As the key factors of divergence after introduction of euro in Portugal I have to mention first the risk of decreasing interest rates in these economies which could result in credit boom, and second the over optimistic rise of real wages which is not followed by the increase of productivity. It means the solutions could on the one hand be that wage increases are not based on over optimistic expectations, and on the other hand, fiscal policy has to be more restrictive when high economic growth is boosted by domestic factors.

EURO ADOPTION PLANS IN BULGARIA AND ROMANIA

One can observe that the countries joined the EU in 2004 are expected to adopt euro 7-8 years after their accession instead of a rapid introduction of the single European currency. This is an important lesson for the newly acceded countries. However, Bulgaria and Romania adopted a different euro introduction strategy.

It seems Bulgaria plans to follow the path of the Baltic states and try to adopt euro as soon as possible after the EU accession and accordingly, Bulgaria will enter into ERM II regime this summer. According to Bulgaria's goal, the Maastricht criteria will be fulfilled till 2008-2009, thus euro can be introduced in 2010. Considering these criteria one can see that most of them are fulfilled and only inflation rate is higher than the reference.

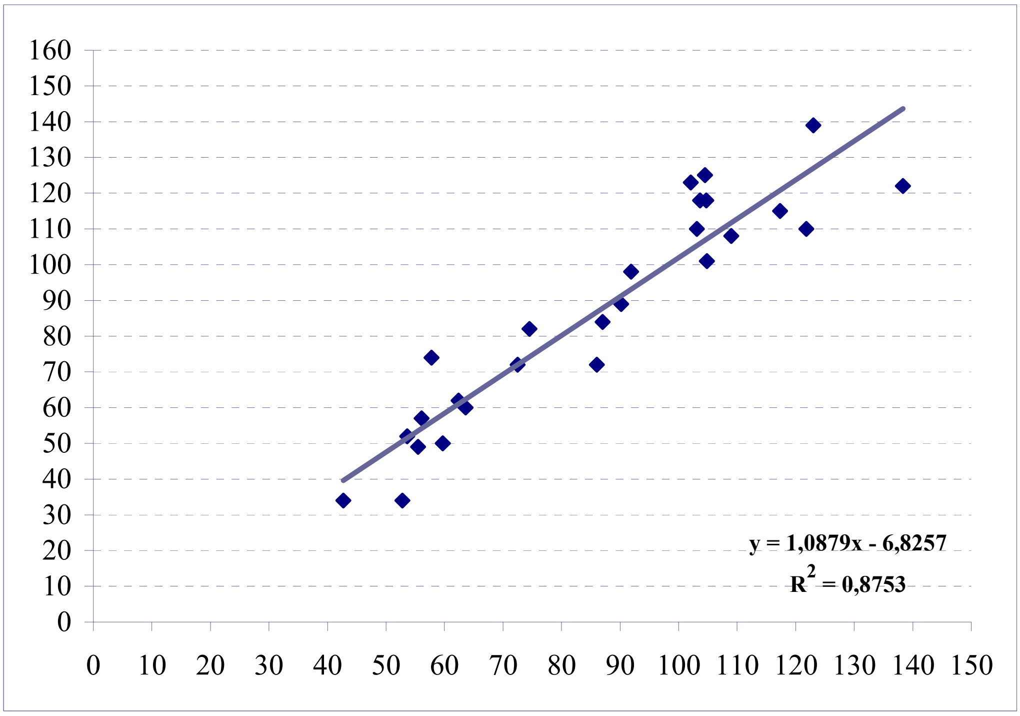
Besides that, one can observe more similarities with Baltic states. First, Bulgaria also introduced a currency board arrangement, thus monetary policy is limited. Second, a significant credit boom was observable in Bulgaria, which was boosted by households' consumption, and in line with that real wages has also risen significantly.

The Bulgarian economy grows dynamically fuelled by investments and consumption, and attracting significant amount of FDI. In that economic and policy environment, Bulgaria should decrease its inflation rate to under 3% from last year's 7.4% to fulfil the related criterion. It is not impossible but a bit over optimistic and includes several risk factors.

Bulgarian National Bank plans to decrease inflation rate to 3.7% at the end of 2007 and under the reference value in the next year so as to be able to adopt euro in 2010. However, it needs a significant disinflation in next years as well. Disinflation is an aim in such a situation when the country joined the EU, its contribution to EU budget increased, prices are increasing in line with the harmonisation measures and business climate improves drawing more and more foreign investments into the country.

It is worth mentioning that Bulgaria's price level is the lowest in the EU. Since price level and economic development (GDP level in PPS) are in strong correlation, accordingly high economic growth results in convergence in price levels as well. Price convergence is expected to occur via inflation due to the fact that exchange rate is fixed. However, it is also true that this problem can be handled in short/medium term.

Correlation of GDP (PPS) and price level in EU countries, 2005



Source: Eurostat, own calculations
Note: EU average = 100; x – price level, y – GDP (PPS)

Unemployment decreased to under 10% recently and the limitation of supply of workforce is expected which could result in wage increases. Accordingly, significant increase of wages could raise inflationary pressure. Wages in Bulgaria are the lowest in the EU, even lower than those in Romania.

All these aforementioned factors mean that Bulgaria faces serious challenges to adopt euro until 2010. However, it is not an unrealisable strategy but a quite ambitious one. Thus, it could result in the delay of the introduction of euro in Bulgaria by one or two years.

Romania prepared a completely different strategy. The Romanian government and central bank plans to introduce euro in 2014, which means that Maastricht criteria will be fulfilled to 2012 when the country will enter into ERM II regime as well. Romania decided to apply a later adoption of the euro to be able to make some real convergence before the introduction of the single European currency. Certainly, it does not mean complete convergence since real figures of the country are lagging behind significantly from EU average and even from Eastern EU member states. It means only further convergence to the EU in real terms. One can consider this strategy as a better-grounded preparation for the adoption of euro based on the lessons of the Central and Eastern European countries joined the EU in 2004.

Summary table

	Maastricht criteria					Number of fullfiled criteria
	Inflation (HICP, %)	Government: Fiscal balance (% of GDP)	Government: Public debt (% of GDP)	Long term interest rates (%)	ERM-II membership	
	April 2007	2006	2006	April 2007	April 2007	
Reference	3.0	-3.0	60.0	6.04	2-year membership w/o tensions	-
Bulgaria	4.4	3.3	22.8	4.22 (March)	-	3
Romania	3.8	-1.9	12.4	5.90 (Jan)	-	3
Czech Republic	2.7	-2.9	30.4	3.92	-	4
Poland	2.2	-3.9	47.8	5.28	-	3
Hungary	8.7	-9.2	66.0	6.65	-	0
Slovakia	2.0	-3.4	30.7	4.26	Since November 2005	4
Estonia	5.6	3.8	4.1	5.13 (March)	Since June 2004	4
Latvia	8.8	0.4	10.0	5.52	Since May 2005	3
Lithuania	4.9	-0.3	18.2	4.24	Since June 2004	4

Source: Eurostat, national sources

Similarly to Bulgaria the hardest goal to achieve related to Maastricht criteria is to lower inflation rate to under the reference value. In Romania disinflation has been a long process. Inflation rate exceeded 150% in 1997 and it declined under the 10% threshold only in 2005, for the first time after transition. In line with that central bank shifted to inflation targeting regime, while the national currency appreciated in real terms as well. These factors helped the National Bank of Romania to lower the inflation rate to the single digit range.

Regarding current developments, one could say that Romania did not prepare a too ambitious euro adoption plan. Now it seems that the Southeast European country could join the euro zone well before the planned date (2014). Regarding however the examples of the CEE states and their delayed accession schedules, it seems quite wise decision to set a date, which is credible and not too risky.

Romanian economic growth is sound and based on private consumption and investments. High consumption growth (more than 10% annually in recent years) is fuelled by rapid increase of real wages and significant credit boom in the country. It means that significant inflationary pressure characterised the economy in the last years. In the first months of 2007 CPI declined to under 4% in Romania, however, it must be mentioned that the record low inflation was the result of the favourable progress of foods products. Besides that, strong Leu also contributed to lower inflation rate in Romania.

The National Bank of Romania targeted 4% and 3.8% end-year inflation rate for 2007 and 2008 respectively which are completely in line with the planned convergence path. However, it is also worth mentioning that interest rate policy is not always in accordance with inflation policy aims and sometimes it seems considering competitiveness aspects.

Finally, another factor must be considered related to this issue. Romania as an EU member must contribute to EU budget and co-finance EU projects, thus the burdens of the budget are expected to grow. Accordingly, fiscal deficit can be close to 3% of GDP this year. While the economy grows by 6-8% annually this factor will not cause serious problems, however the lessons of CEE member states show that these years should be used to implement reforms and to avoid the traps that some of these countries walked into.

CONCLUSION

The starting point of the newly acceded countries can be considered as good related to convergence criteria. At first glance it seems that euro adoption can be realised soon in both Southeast European countries. Only the reduction of inflation rate can cause problems similarly to the Baltic countries. Despite of the fact that the euro adoption strategies of these two countries are different the challenges are quite similar: price level is low, real wages increase significantly, economic growth is high fuelled by domestic demand, mainly private consumption and investments, accordingly significant inflationary pressure characterise these countries. Thus, the risk of the fast Bulgarian euro adoption is high; accordingly, it can be delayed to 2011-2012.

Romania seems to have learned the lessons of the CEE countries and prepared a less ambitious schedule. Euro adoption will be realised only after some catching-up of the country. It seems that the authorities in Romania see correctly the challenges that the country faces.

Certainly, the different euro adoption strategies can be partly explained by the different exchange rate regimes as well. While the entry into ERM II regime will not affect significantly the monetary policy of Bulgaria, Romania will have to give up its autonomous monetary policy and managed floating will not be a useful tool to achieve the central banks aim. This exchange rate regime will be given up by Romanian authorities only if the period of being in ERM II regime can be decreased to the minimum (2 years).