EU enlargement - Recent economic developments and challenges for EU membership Part II

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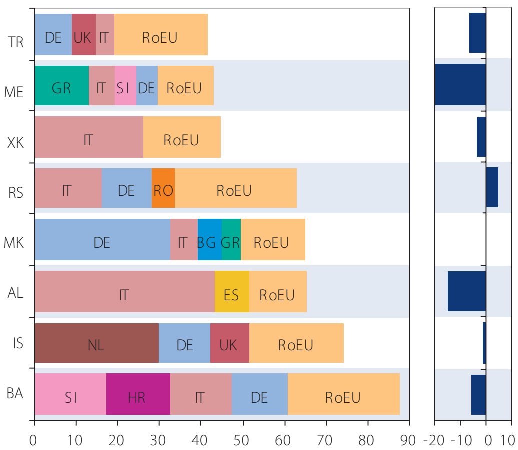
Building upon the previous part (Országhová, 2014), this article reviews the macroeconomic situation in EU candidate and potential candidate countries in the aftermath of the economic crisis. Furthermore, it highlights challenges for sustainable convergence that remain ahead on the road to EU membership. While all countries are analysed as a group as much as possible, given the high heterogeneity among them, some country-specific characteristics are discussed whenever relevant.

Strong economic and financial linkages with the European Union

The candidate and potential candidate countries[3] are a group of diverse economies that share the common perspective of joining the EU once they are ready. They have all undergone the process of European integration, which has resulted in a unique combination of political and institutional anchoring as well as deep economic, trade and financial integration with the EU.

One of the strongest channels of European integration has been the foreign trade. Trade relations are part of overall political and economic strategy of the EU towards the EU candidate and potential candidate countries, with the establishment of a free trade area regarded as the final goal. Nowadays, Iceland participates in the EU single market, Turkey has a custom union with the EU, applying thus common external tariffs, and all Western Balkan countries were granted autonomous trade preferences, allowing almost all exports from these economies to enter the EU without any quota limits or custom duties. The EU relations with the Western Balkan region are further governed by the Stabilisation and Association Agreements,[4] which aim to establish progressively a free trade area between the two regions.

Chart 1 Exports to EU (Share in total exports in 2012, change from 2008)



Sources: IMF, National Statistical Offices and author's calculations.
Note: For readability purposes, any share smaller than 4% is included in RoEU (Rest of EU).

As a consequence, the EU has become the region's largest trading partner for both merchandise exports and imports.[5] Despite some rebalancing since the crisis, EU accounted on average for more than half of total trade flows in 2013, with Bosnia and Herzegovina and Iceland displaying the highest dependency on the EU for their exports (both overpassing 70% of total export, Chart 1) and FYR Macedonia and Albania for their imports from the EU (reaching 65% and 74% respectively). Some bilateral trade figures are also worth mentioning, notably Albania is strongly dependent on developments in Italy (43% of all country's exports), FYR Macedonia on Germany (more than 30%) and Iceland on Netherlands (almost 30%).[6] All countries with the single exception of Iceland are continuously posting trade deficits with the EU.

The EU has been the most important source of the financial flows for the EU candidate and potential candidate countries. In some countries, notably Montenegro, Serbia and Iceland, these stocks represent more than 50% of countries' annual GDP. In addition, more than half of all FDI flowing into the region stem from the EU and there seems to be very little diversification from this trend since the crisis. The dependence on the EU is in particular high for Serbia, FYR Macedonia and Iceland where the FDI from the EU accounts for more than 80% of all FDI stocks (Chart 2). It is the lowest in the case of Montenegro, given the country's large exposure to FDIs from Russia (13% of FDI stocks in 2012). It is worth mentioning that Icelandic outward FDI stocks in the EU countries have reached roughly an equal magnitude as the EU investments in the country.

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2 *The author would like to acknowledge the comments and suggestions by Francois Gurtner and Vladimír Martvoň. The article should not be reported as representing the views of Národná banka Slovenska (NBS) or any other institutions the author has been associated with. The views expressed and mistakes made remain of the author.*
3 *The group covers Albania (AL), Iceland (IS), Montenegro (ME), the former Yugoslav Republic of Macedonia (FYR Macedonia, MK), Serbia (RS) and Turkey (TR) that have been granted a status of a candidate country as well as Bosnia and Herzegovina (BA) and Kosovo under UN 1244/99 (XK) that have been recognised as potential candidate countries. For details, refer to Orszaghova (2014). The designation of Kosovo does not constitute a position on the status of this territory and is in line with UNSCR 1244/99 and the opinion issued by the International Court of Justice on Kosovo's declaration of independence.*
4 *An Interim agreement on trade and trade-related matters is in place in the case of Bosnia and Herzegovina. Moreover, the EU has recently finalised negotiations on the Stabilisation and Association Agreement with Kosovo.*
5 *Bilateral service trade data are not available for the countries in review. Exports of services are important in particular for Montenegro (more than 70% of total exports value in 2013) and Kosovo (over 65%), but they are also significant for Albania and Iceland (over 40%). Given the high share of travel services in total services exports and high share of tourists from the EU in these countries, the author assumes that the EU is one of the major trading partners also for trade in services.*
6 *Furthermore, many economies in the Western Balkans have a large trade exposure to their neighbours, i.e. 22% of Montenegro's exports*

A large part of foreign direct investments from the EU in the Western Balkan region is related to the privatisation process of the domestic banking sector. The EU-headquartered banks have developed a strong presence in the region, accounting for 55-85% of banking system assets (Chart 3). Following the crisis and the state-aid cases for some EU-based banking groups, gradual deleveraging is taking place and some banks have been encouraged to scale down their presence in the region.[7] From the institutional perspective, with the establishment of the Single Supervisory Mechanism in November 2014, the bulk of the EU-based banks present in the Western Balkans will be considered significant, and as a consequence, the European Central Bank will become the host supervisor for a large part of the banking assets in the Western Balkans. Turkish and Icelandic banking sectors are primarily domestically owned, however Iceland expanded aggressively in the pre-crisis period in some EU countries, namely the Netherlands and the UK.

Furthermore, remittances from the EU are non-negligible financial flows for the Western Balkan economies, accounting for 6% of countries' GDP on average in 2012.[8] They are related to large waves of emigration to EU Member States in the recent history, in particular from Albania, Bosnia and Herzegovina and Kosovo,[9] as a result of the economic transition in the 1990s and the series of conflicts in the territory of the former Yugoslavia (1991-1999). Remittances from the EU thus represent the bulk of all migrant flows for the Western Balkan economies, reaching around 80% of total remittances on average.

The single European currency is also widely used in the majority of the EU candidate and potential candidate countries. The use of euro is most widespread in the Western Balkans, where it continues to be perceived as a preferable store of value relative to local currencies, particularly in those countries which had previously experienced periods of macroeconomic instability. Despite the crisis, the euro's share in total foreign deposits has remained broadly unchanged on average.[10] As a result, the euroisation of both assets and liabilities on banks' balance sheets remains substantial in the Western Balkans. This has been also reflected in countries' policy choices, where many countries use euro as an external anchor for their foreign exchange policies (Table 1).

The European enlargement process has been a unique combination of institutional anchoring and trade and capital-markets integration. Despite some diversification since the onset of the crisis, the close integration with the EU continues to serve as a policy anchor for the countries in review.

Pre-crisis and post-crisis experience: On a search for a new growth model

EU candidate and potential candidate countries share a number of characteristics in their pre-crisis as well as post-crisis developments. In the period between 2003 and 2008, they all experienced a robust annual growth (in the range of 4-7% per year on average), driven largely by their integration with the EU. Iceland, the only advanced economy in the group, has also achieved considerable growth, largely outperforming the other advanced economies. This has led to a period of rapid catching up with the EU across the board (Charts 4 and 5).

However, the pre-crisis growth has led to economic structures that made many of these countries more prone to the crisis as the seemingly fast and smooth growth before the crisis was accompanied by rising vulnerabilities. It was to a con-

are directed to Serbia and 15% of Kosovo's exports to Albania. If considered together, the interdependence on the developments in broader Europe would reach almost 80% of exports on average for these countries.

7 *See i.e. the state case aid number SA.32554 on Hypo-Alpe Adria (September 2013), where the European Commission approved a plan to sell the South-Eastern European network by 30 June 2015 at the latest as well as the case number SA.34825 on Eurobank (April 2014), the case number SA.34824 on Bank of Greece (July 2014) and the case number SA.34823 on Alpha Bank (July 2014), which provide for further restructuring and deleveraging of international operations of these three Greek banks. The case number SA.33229 on Slovenian NLB (December 2013) is less specific on the future of its international network.*

8 *In comparison, the relevance of remittances for Iceland and Turkey is lacklustre (reaching 0.13% and 0.14% of GDP respectively in 2012). Source: World Bank, IMF and author's calculations.*

9 *The EU diaspora represents more than 20% of the population living in Albania and Bosnia and Herzegovina. Data on bilateral remittances inflow and on diaspora for Kosovo are not available, but the country's overall levels of remittances are the highest within the group (reaching 16% of GDP in 2012).*

10 *See also OeNB Euro Survey.*

Chart 2 FDI stocks from the EU (share in total FDI inward stocks in 2012, change from 2008)

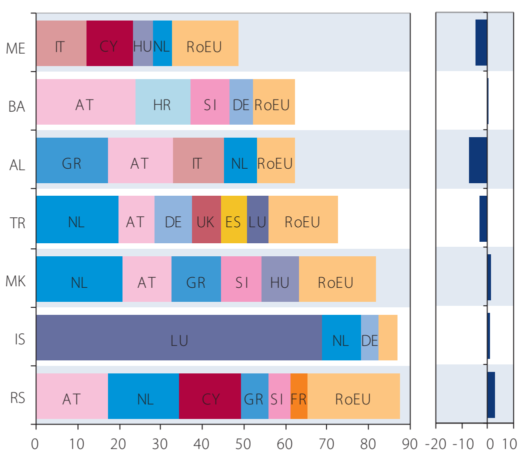
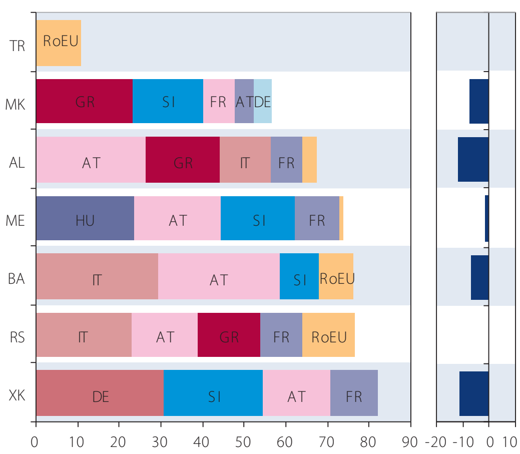


Chart 3 EU-headquartered banks (share in total banks assets in 2012, change from 2008)



Sources: UNCTAD, Bankscope, National Statistical Offices and author's calculations.
Note: For readability purposes, any share smaller than 4% is included in RoEU (Rest of EU).

Chart 4 Real GDP growth
(annual percentage change of real GDP)

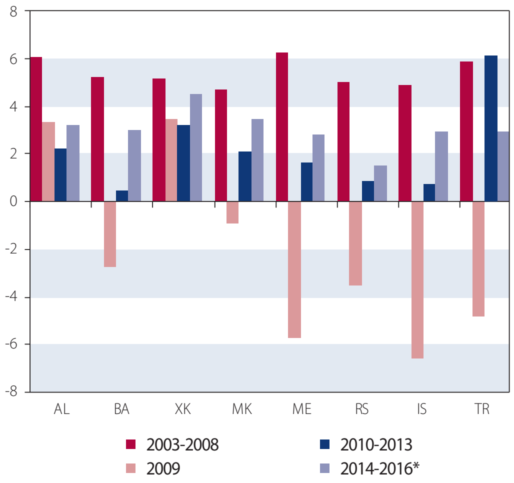
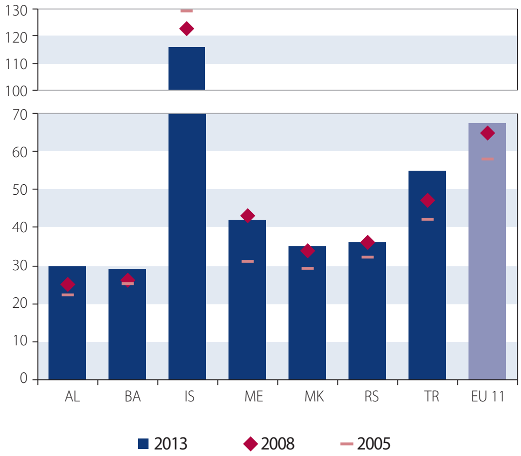


Chart 5 GDP per capita in PPS
(index, EU-28=100)



Sources: Haver Analytics, IMF (indicates projections), Eurostat and author's calculations.*
Notes: EU11 covers all EU member states that joined the EU since 2004, except Cyprus and Malta. A simple average is used to calculate the regional aggregate.

11 Domestic credit in Montenegro and Iceland, measured as credit to the private sector over GDP, increased by 63pp and 75pp respectively between 2003 and 2008.

12 This designation does not constitute a position on the status of this territory and is in line with UNSCR 1244/99 and the opinion issued by the International Court of Justice on Kosovo's declaration of independence.

siderable extent fuelled by consumption and unsustainable inward-oriented booms in credit and housing. This led to high current account and trade deficits and accumulation of large external liabilities. The growth in domestic credit, facilitated by increasingly liberalised (foreign-owned) banking system, skyrocketed in particular in Montenegro and Iceland.[11] Also, housing prices grew much faster, inflation rose considerably and real exchange rate appreciation was also more rapid before the crisis. The trade and current account balances reached double-digit levels in several cases (i.e. Serbia and Montenegro). Furthermore, the economic growth was financed externally, as capital flowed into the countries on the back of benign external environment, EU accession prospects and in many cases it was propelled by some reform record (i.e. trade liberalisation, banking reform). However, the composition of foreign direct inflows progressively shifted toward debt-creating non-FDI flows, in particular in favour of banking, real estate and other domestic sectors. Some countries allowed little exchange rate flexibility. In the face of massive capital inflows, it was impossible for them to lean against the nominal appreciation and complete sterilization via foreign currency purchases. Thus, higher inflation lowered real interest rates, fuelling credit booms and aggravating external vulnerabilities. This led to an erosion of competitiveness and a less vibrant expansion in the world export markets. Moreover, fixed exchange rate regimes reduced perceptions of the exchange rate risks and contributed to overleveraging and high degree of financial euroization.

The EU candidate and potential candidate countries were hit hard by the shockwaves of the global economic crisis in 2009, with a time lag to the general European and global trends (Chart 4). All countries suffered from falling demand for imports in main export destinations and from liquidity withdrawal, notably from the EU. However, critical heterogeneity was recorded within the group. It can be partially explained by countries' different vulnerabilities and reliance on pre-crisis capital inflows, different level of financial and trade linkages with the EU (and with the EU crisis countries in particular), their reliance on commodity exports (i.e. crude oil for Albania) as well as the space for fiscal and monetary policy stimulus to dampen the effects of the crisis. The most vulnerable countries, notably Iceland and Montenegro, experienced a real economic contraction of above 5%, reflecting a sudden stop of capital flows and sharp fall in domestic demand. On the other hand, Albania and Kosovo[12] belong to the few European economies that experienced a slowdown, but avoided a recession in 2009, on the back of their lower economic and financial integration.

Large heterogeneity exists when it comes to the post-crisis developments. The recent economic and financial crisis has had a profound effect on EU candidate and potential candidate countries from the Western Balkans. It has brought a period of stagnation (or subdued growth) with no immediate prospect for a bounce back. Despite the tentative recovery in 2010-11, most of these economies have taken another plunge in 2012, largely owing to the deteriorating conditions in the EU. The recovery is in general slow, falling behind pre-crisis growth, and it is also slower than in other emerging countries' groups. As a consequence, their convergence with the EU has stalled since the crisis (Chart 5). Albania and Kosovo have displayed more resilience in the face of headwinds from the global financial crisis and they have followed a pattern of subdued, but resilient growth. However, Albania's economy has been gradually slowing down (reaching annual GDP growth of 0.7% only in 2013) and it has shown signs of protracted weakness, following a drop of remittances (and even a reverse migration) from EU crisis countries, notably Greece. The resilience of Kosovo owes primarily to the near-absence of financial or export linkages to crisis countries as financial flows from the Kosovar's diaspora (mostly residing in Germany and Switzerland) continue to support domestic demand and finance a wide trade deficit. In general, the turmoil derailed the Western Balkan economies from their pre-crisis pace of growth, impairing productive capacity and balance sheets, raising unemployment and sharply lowering capital formation. Moreover, external and fiscal challenges persist and as a consequence, many of these economies reverted to the IMF for external assistance.[13]

Both Iceland and Turkey seem to bounce back from the downturn in 2009. Iceland posted sustainable growth levels as of 2011, whereas Turkey's economic growth skyrocketed in the two years following the crisis. It was achieved on the back of pro-cyclical macroeconomic policies and driven by credit expansion and underlying domestic demand (reaching 9% on average in 2010-2011). Furthermore, the country continues to outperform the other EU enlargement countries, although at a slower pace. Exports were a bright spot for the two economies, thanks to successful diversification towards Middle Easter and Northern Africa in the case of Turkey and towards energy and tourism sectors in the case of Iceland. Notwithstanding this, the two countries face several post-crisis vulnerabilities, which might weight on their future growth prospects. Iceland's policy priorities are related to the legacy from the collapse of the banking sector (Box 1), whereas Turkey is facing the task of managing economy's soft landing in the environment of domestic political uncertainties and changing global liquidity conditions.

The sharp economic contraction during the crisis and the relative underperformance of the region during the past few years have triggered a policy discussion about the prevailing growth model and the prospects for further convergence. The close ties with the EU facilitated the strong performance of these economies in the pre-crisis period; however they also explain how the crisis spread quickly to the region and amplified the weak fundamentals in many of the economies. As such, the roots of the crisis in these economies lay with the policy choices of the countries themselves and not in the EU integration model. The crisis has shown that macroeconomic policies have a crucial role in guiding private sector behaviour and ensuring the sustainability

Box 1

Icelandic crisis experience: From a meltdown to a miracle?

Icelandic experience is worth highlighting, given the magnitude of the imbalances accumulated prior to the crisis as well as the subsequent downturn and policy reaction by the Icelandic authorities. Following the liberalisation and privatisation of the banking sector in early 2000s, the three major banks in Iceland[14] expanded their investment activities both domestically and abroad, fuelled by capital flows stemming from the abundant global liquidity. The banks financed their expansion from abroad, primarily via short-term loans, but non-resident deposits also played an important role, in particular via retail customers in the UK and the Netherlands. By 2007, the majority of the banking activities took place outside Iceland and the three banks' foreign currency liabilities reached 750% of country's GDP in September 2008. Furthermore, this development was accompanied by a domestic credit-fuelled boom in consumption and investments, leading to external imbalances and asset price bubbles. Furthermore, a large part of residents' debt was either in foreign currency or inflation indexed, seriously impairing the room for manoeuvre of the monetary policy regime.

Following the collapse of Lehman Brothers in September 2008, the banking system in Iceland got disintegrated and defaulted on its external debt within a few weeks. This was accompanied by strong currency depreciation against euro, a surge in public sector debt and a sharp decline of GDP (by 6.6% and 4.1% of GDP in 2009 and 2010, respectively). The country had to revert to a Stand-By Arrangement by the IMF (SDR 1.4 billion), the three major banks were placed in resolution regimes and the country introduced capital controls in November 2008, in order to stabilise its exchange rate and to prevent outflows.

The economy has staged a laudable rebound since 2011, reaching a growth rate of above 3% as tourism, fishery, energy and information technology have replaced the banking sector as main drivers of growth. Pre-crisis current account deficits of double digits were turned into current account surpluses as of 2009. Furthermore, the country has successfully exited the IMF programme in 2011. However a large unfinished policy agenda related to crisis legacy remains until today, weighting heavily on prospects of durable growth: The country is facing the tasks of an orderly lifting of capital controls and of settling the debts of failed financial undertakings without threatening economic and financial sector stability.

13 Since the onset of the crisis, Bosnia and Herzegovina, Serbia as well as Kosovo had each two Stand-By Arrangements (SBA), FYR Macedonia opted for a Precautionary and Liquidity Line (PLL) and Albania has recently concluded an Extended Fund Facility (EFF).

14 Kaupthing, Landsbanki and Glitnir (in order of the size of their assets).

15 Report by the (ECOFIN) Council to the European Council in Nice on the exchange rate aspects of enlargement, Brussels, 8.11.2000, Council of the European Union press release no. 13055/00.

of convergence. The EU candidate and potential candidate countries face common challenges to strengthen their economic growth process from the supply-side, increase labour and product market flexibility and participation and accelerate structural reforms. Furthermore, more attention needs to be given to fiscal and financial stability developments. The recent crisis serves as a reminder that the quality and sustainability are key elements of a lasting convergence and that sustained policy efforts are needed to fully exploit the economic benefits of the European integration.

Monetary policy: Multiple challenges on the back of limited policy choices

As summarised in Table 1, the EU candidate and potential candidate countries have opted for a broad range of monetary policy and exchange rate regimes. Euro plays a pre-dominant role in the monetary and exchange rate arrangements of Western Balkan economies: Most countries have pegged their exchange rates (formally or informally) to the euro, and those with some degree of flexibility are limited by their relative large FX liabilities. With respect to Kosovo's and Montenegro's euroisation, it is worth highlighting the ECOFIN Council position (November 2000)[15] which states that unilateral euroisation runs counter to the underlying economic reasoning of the Economic and Monetary Union. As to the other two candidate countries, the monetary policy in Iceland has focused on exchange rate stability as an interim target on the back of introduced capital controls following the crisis, whereas Turkey has progressively adopted a more unorthodox policy mix as of 2010 (Box 2).

Table 1 Monetary policy and exchange rate regimes

	Currency	Monetary policy framework	Exchange rate arrangement	
			De jure	De facto
Albania	Albanian lek	inflation-targeting	free float	float
Bosnia and Herzegovina	convertible marka	exchange rate anchor vis-à-vis the euro	currency board	currency board
FYR Macedonia	Macedonian denar	exchange rate anchor vis-à-vis the euro	float	stabilised arrangement
Iceland	Icelandic krona	inflation-targeting *	free float	float
Kosovo	euro	exchange rate anchor vis-à-vis the euro	no separate legal tender	no separate legal tender
Montenegro	euro	exchange rate anchor vis-à-vis the euro	no separate legal tender	no separate legal tender
Serbia	Serbian dinar	inflation-targeting	free float	float
Turkey	Turkish lira	inflation-targeting	free float	float

Sources: IMF and author's compilation.
*Note: * Exchange rate stability as an interim target as of 2009.*

Box 2

Monetary policy regime of multiple objectives in Turkey

Faced with extreme volatility in cross-border capital flows and in the exchange rate, rapid credit growth and a sharp deterioration in the current account deficit in the post-crisis period, the central bank of Turkey has progressively modified the conventional inflation targeting regime by adopting a more unorthodox policy mix as of 2010, also referred to as "*flexible inflation targeting*". Besides its primary objective of price stability, financial stability has been followed as a supplementary objective. Furthermore, a wide range of complex instruments were introduced alongside the policy rate, such as interest rate corridor, reserve requirement ratios staggered according to the maturity and currency denomination of bank's liabilities as well as reserve option mechanism, allowing the banks to hold a share of their unremunerated reserve requirements in foreign currency or in gold, using a system of reserve options coefficients and reverting to direct FX interventions and auctions.

The new framework of monetary and macroprudential policies of the central bank has been successful in achieving some short-term objectives, i.e. it has contributed to economic rebalancing in 2012, reduction in exchange rate volatility and a build-up of foreign exchange liquidity buffers of the central bank. However, it appears that these results have come at the expense of some non-negligible shortcomings. The changing priorities and multiple short-term objectives have resulted in a persistent failure of the central bank to bring inflation within its target (5.0% ±2pp uncertainty band) and inflation expectations have become increasingly de-anchored. Furthermore, the complexity and ambiguity of the framework has introduced some deliberate noise in monetary policy communication and thus compromised its transparency and predictability.

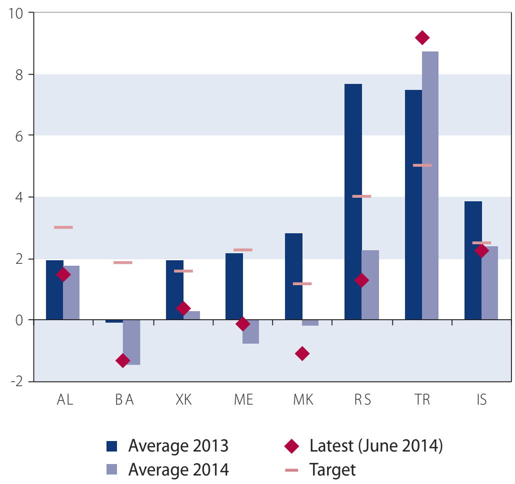
The shortcomings of the framework were demonstrated in January 2014, where the central bank, in an emergency meeting, tightened sharply its monetary policy stance, following the strong depreciation of Turkish lira in the environment of domestic political instability and international transition from abundant to tighter global liquidity following the Federal Reserve's tapering announcement in May 2013. The 1-week repo lending rate was raised from 4.5% to 10%, followed also by increases in overnight lending and borrowing rates. This resulted in streamlining of the policy framework. Furthermore, the 1-week repo lending rate was reinstalled as the main policy rate in the process, putting a clearer focus on the main objective of price stability.

All candidate and potential candidate countries, with the exception of Turkey, are currently experiencing a period of historically low inflation, with current annual inflation levels below the target (Chart 6). Annual inflation declined sharply over the course of 2013, in particularly in Serbia,[16] but also in countries, which have a limited policy freedom due to a (de jure or de facto) peg of their currencies to the euro. Furthermore, it has dipped into negative territory in Bosnia and Herzegovina and Montenegro, which have posted negative annual growth rates for 11 and 6 consecutive months, respectively, as well as in FYR Macedonia, though for a short 3-month period of time only. Disinflationary pressures are to a large extent imported, following the developments in the EU and falling international/regional energy and food prices. Furthermore, given a limited monetary policy toolkit of the 'peggers' to help absorb external shocks, it is also possible that the downtrend in the general price level could reflect an 'internal devaluation' in the face of weak economic activity and fiscal consolidation measures. Going forward, the outlook for inflation in the region is muted and inflation rates will remain well below the targets for 2014 and only returning towards the target in the medium-term.

Furthermore, the slowdown of the economic activity has been associated with weak credit growth. The contraction of the lending activity has been driven mostly by the corporate sector, which dominates the credit portfolio. Lack of credit growth is a wide spread phenomenon in the Western Balkan region as well as in Iceland. The lack of bank lending channel represents a triple challenge, as it exacerbates credit risks for financial stability, hampers the efficiency of monetary policy by impairing the monetary policy transmission mechanism and it casts serious doubts about the prospects for sustained economic growth in the absence of accompanying credit dynamics. According to available information, the credit performance has reflected both the supply and the demand side. The household behaviour seems to be impacted by the overall negative economic situation and uncertainty in the labour market.[17] On the corporate side, the decline could be associated with the lack of new investment possibilities due to low economic activity, scare liquidity and deteriorated financial situation. As a consequence, the loan requests were oriented towards working capital loans. On the supply side, tighter lending conditions seem to be put in place, as a response to increasing level of non-performing loans (NPLs), which are weighting on the profitability of the banks and erode their capital base[18] as well as the result of the new regulatory framework imposed by the parent banks, putting more pressure on tightening of the lending standards.

Since the crisis, several measures, both on monetary and macro-prudential side have been applied by the authorities in order to react to the on-going situation. Central banks have eased their monetary policy stance to historically low levels, however the monetary policy remains in many cases tighter than warranted by the economic fundamentals, given the constraints related to the

Chart 6 Inflation
(annual percentage change)



Sources: Haver Analytics, central banks, IMF and author's calculations.
Notes: Simple averages of monthly inflation figures for 2013 and 2014. If not defined by the central bank, the target inflation was calculated using the WEO average inflation figures for 2014-2018.

16 Serbia's inflation felt by almost 11pp, from an above-the-target peak of 12.5% y-o-y in January 2013 to 2.2% in December 2013. It fell further down to 1.3% y-o-y in June 2014.
17 It has been reflected in the high propensity to save, as indicated by the increase of deposits or holdings of other assets by the households.
18 NPLs are in particular high in Albania and Serbia.

19 *Automatic stabilizers are defined as components of fiscal policy that are incorporated in the legislation, whereas discretionary policy refers to measures undertaken by policymakers as a reaction to new developments.*

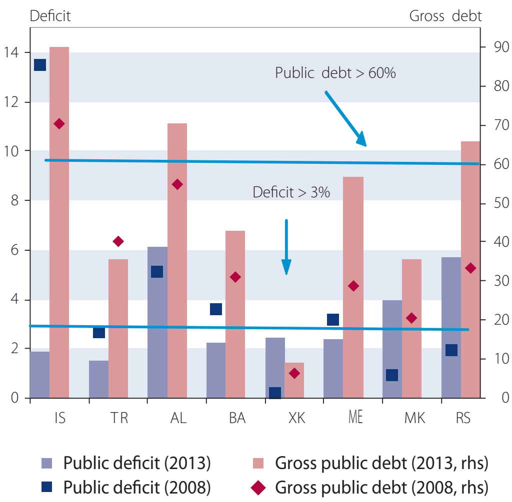
need to take into account exchange rate movements (i.e. Serbia). Furthermore, many countries reverted to frequent interventions in the foreign currency market (i.e. Serbia) or increased the transparency of their monetary policy communications (i.e. Albania by introducing forward guidance). Furthermore, all Western Balkan countries have been actively changing reserve requirements and reserve bases in order to influence lending in the economy, differentiating between domestic and foreign currency loans in the process in order to tackle the high euroisation of the economies. From the macro-prudential measures, the easing of liquidity and capital requirements as well as the relaxation of NPL classification for restructured loans was also implemented. Some countries in the Western Balkans introduced new measures with the aim to resolve high NPL ratios, i.e. collateral execution framework in Albania or special purpose vehicle in Montenegro. The effect of the measures so far has been very limited.

Looking ahead, the revival of credit will remain one of the priorities for the policy makers. It shall be noted however that there is a natural limit to measures that could enhance credit expansion since relaxing the credit conditions might create a problem in the future.

Fiscal policy: Refocusing on fiscal sustainability

The crisis has taken a high toll on the fiscal positions of most EU candidate and potential candidate countries. In the pre-crisis period, fiscal balances were rather benign, with the exception of Albania during the whole pre-crisis period and Turkey in the aftermath of the economic crisis in early 2000s. Moreover, the countries had somewhat more comfortable fiscal space as they

Chart 7 General government gross debt and net borrowing (in percent of GDP)



Sources: Haver Analytics, IMF, national Ministries of finance and author's calculations.
*Note: * Data for 2009 in the case of Kosovo.*

started the period with fairly low debt levels, not overpassing Maastricht convergence criterion of 60% of debt-to-GDP ratio. This enabled them to pursue expansionary fiscal policies for a relatively long period, generally without bringing into question the issue of debt sustainability.

The fiscal policy was not the primary contributor to the build-up of external vulnerabilities in the pre-crisis period. The fiscal balances were rather improving and public debt was falling in most of the countries, including Western Balkans where the fiscal policy environment was affected by the specifics of the transition process and the post-war reconstruction. However, the crisis has shown that the policymakers failed to fully appreciate the cyclical nature of the fiscal policy. From the perspective of most of the economies, the impact of the crisis on the fiscal policy stance was triggered by a combination of a collapse in revenue collections and an increase in expenditures, often driven by high level of state subsidies and transfers. The data suggest that discretionary policies in particular exacerbated cyclical economic movements, whereas the automatic stabilisers had some countercyclical effect.[19]

Fiscal policy has been rather profligate over the last several years, with an upward trend in public deficits in most of the economies. As a consequence, the public debt has risen continuously, albeit from relative low levels in most of the cases (Chart 7). Debt levels are in particular high in Albania and Serbia, overpassing 70% and 65% of GDP respectively (deficit levels are also high in these two economies). Furthermore, Iceland also reports high debt levels (of over 90% of GDP) on the back of bank rescue.

Most countries have very limited fiscal policy options, in particular in light of the significant financing constraints given recent changes in the global economic environment, generally lower quality of fiscal institutions and volatile investors' confidence. Although public debt relative to GDP is considerably lower in most countries than in advanced economies, market tolerance for public debt in these countries is also lower. Furthermore, changes in the global economic environment have led to external financial constraints and a significant change in the medium/long-term economic outlook also weights strongly on the fiscal balance. The deteriorating public finances are of concern not only in view of fiscal sustainability and wider economic performance, but also from the point of view of monetary policy making.

Looking ahead, medium-term fiscal policy in all countries needs to focus on ensuring fiscal sustainability, bearing in mind the fragile nature of the economic recovery and the need to implement key structural reforms to address longer-term fiscal challenges, such as demographic changes and increasing age-related expenditures. Measures to eliminate the amplifying effect of discretionary measures on economic fluctuations are also warranted. In this respect, adoption of medium-term fiscal rules and their rigorous application might help to reduce volatility. Furthermore, the countries need to pay more attention to debt sustainability issues, including rollover risks.

Structural policies: Challenges of unfinished transition process

With the exception of Iceland, the countries have a considerable scope to catch up with the EU. Average real GDP per capita, as measured by PPP, remains very low and significantly below the EU average (Chart 5). Furthermore, it seems to have stalled in the region since the crisis.

Contrary to many other emerging economies, the key challenge for EU candidate and potential candidate countries is to shift their focus from domestic to foreign drivers of growth. The countries face the non-tradable sector bias in the structure of their economies, as they still have a higher share of traditional sectors (such as agriculture) and a lower share of export-oriented industries. The policies emphasising the strengthening of the productivity and diversification of the external sector would seem to be a prerequisite for the achievement of more dynamic economic activity. They will further unwind the external imbalances that continue to be significant in many countries.

Furthermore, the weak labour market performance is a key social problem, which undermines strongly medium and long-term growth. Whereas Iceland and Turkey post unemployment rates below the EU averages, labour markets in the Western Balkan countries are characterised by some of the highest unemployment (Chart 8) and the lowest employment and activity rates in Europe.[20] Furthermore, their extremely high youth and long-term unemployment rates are also a pressing issue. The situation is most striking in Kosovo, Bosnia and Herzegovina and FYR Macedonia, where almost every third person is unemployed (every second person aged 15-24). Furthermore, high rates of unemployment were present also during the pre-crisis boom years, indicating very low rates of job creation and their little responsiveness to the economic cycle. At the same time, large informal economies could be observed in the countries, which could suggest that the long-lasting labour market weaknesses have structural roots. Going forward, the countries need to reconsider the overall framework of the labour markets, such as the level and targeting of social and unemployment benefits as well as employment protection legislation with the aim to increase labour market flexibility and participation. Furthermore, labour cost factors, including minimum wages, also need to be put in line with productivity gains and general developments on the labour market.

Western Balkan countries have delayed their transition to market economies by the succession wars and the underlying need for post-conflict rebuilding. Despite some significant progress, the economies are still missing some critical reforms, such as privatisation and enterprise restructuring. Together with Turkey, further improvements to institutional competitiveness, business climate and governance are therefore warranted (Chart 9). Many countries still face significant gaps in their judicial systems and in fight against organised crime and corruption, as well as with respect to the abuse of market power. Looking ahead, further real convergence requires profound broad-based structural reforms as the unfinished reform agenda is a drag on growth.

Chart 8 (Youth) unemployment (in percent of total labour force/ aged 15-24 for youth unemployment)

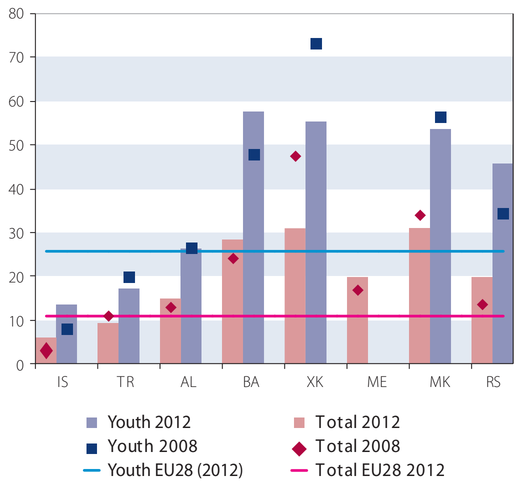
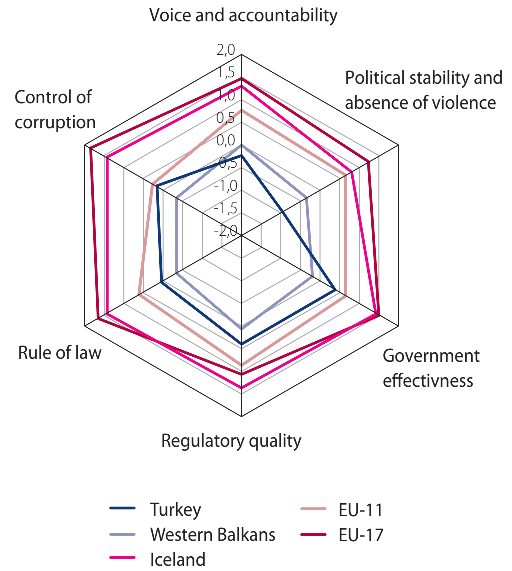


Chart 9 Governance indicators (2012)



Sources: Haver Analytics, IMF, World Bank, national authorities and author's calculations.
Notes: Values for governance indicators belong to (-2.5 ; 2.5). The higher values correspond to better governance. EU-11 is defined as in Chart 5, EU-17 refers to EU countries other than EU-11. Simple averages are used to calculate the regional aggregates.

20 *Activity rate is defined as number of those who are employed or actively seeking employment over working-age population. The average ratio for the Western Balkan countries was less than 50% in 2012.*

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