OESTERREICHISCHE NATIONALBANK
EUROSYSTEM

# WORKSHOPS

## Proceedings of OeNB Workshops

# Recent Developments in the Baltic Countries – What Are the Lessons for Southeastern Europe?

March 23, 2009

Stability and Security.

**No. 15**

# The Current Crisis – a Challenge as Well as a Chance to Implement Needed Reforms?[1]

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## 1. Robust Growth, Real Convergence and High Imbalances

The economy of Bosnia and Herzegovina (BiH) has been exhibiting robust growth (real growth averaged 6% annually between 2003 and 2008) coupled with a low inflation rate over the past five years. Considering its late start to transition and the devastating effects of the 1992–95 war, current level of per capita income in Bosnia and Herzegovina is remarkable. BiHs growth dynamics helped to put it on similar convergence path like other countries at a similar point in transition. Domestic demand has been primary engine of economic growth over the previous periods. Consumption was growing substantially over the whole period, while investment growth was uneven (even negative contribution to the GDP in 2006) over these years, but with significant acceleration in 2007 and 2008. The process of trade liberalization with the EU and within the region (SAA and CEFTA[2] agreements) has been very helpful for promoting trade and expanding the market for export. Privatization was not fully completed as planned due to a lack of political readiness and unresolved ownership rights. However, privatized companies have been very active in raising new capital and creation of jobs, especially where strategic foreign investors found interest for long-term investing.
The persistent imbalance on the external side has even widened in the last two years. The current account deficit refelcts the absorption boom and insufficient domestic saving. The trade deficit has been very large (over 37% of GDP in 2007 and 2008) despite very pronounced export growth in the last three years. An important source of financing of the trade deficit has been workers' remittances

[1] The opinions expressed in this papar are those of the author and do not necessarily reflect the views of the central bank of Bosnia and Herzegovina.

[2] Multilateral trade agreement CEFTA encompasses Bosnia and Herzegovina, Croatia, Macedonia, Moldova, Montenegro and Serbia.

from numerous BiH diaspora as well as workers compensation for temporary employments in the neighboring countries and the EU. Foreign official assistance has not been any more such a significant part of foreign capital inflows, but foreign direct investments (FDI) have become an important source of financing the current account gap. FDI inflows accounted for approximately 33% to 73% of the current account deficit, with exception in 2007 when large-scale privatization attracted FDI over 10% GDP. Despite the large current deficit, international reserves were steadily growing due to large privatization proceeds and banking foreign borrowing till the last quarter of 2008. The external public debt is relatively low (18% in 2007 and 16.7% in 2008) and mostly under concessional terms. Thus the debt service does not pose a severe threat for external liquidity. Total public debt has been estimated[3] at 30% of GDP. Growth of the private external debt has been more intensive, since companies privatized with FDI were able to start foreign borrowing. Total foreign debt is estimated to be still below 50% of GDP, indicating no immediate problems related to foreign indebtedness in the coming period.

*Table 1: Key Macroeconomic Indicators 2004–2009*

| in % of GDP unless otherwise indicated | **2004** | **2005** | **2006** | **2007** | **2008** | **2009f** |
|---|---|---|---|---|---|---|
| Real GDP growth (in %) | 6.3 | 3.9 | 6.9 | 6.0 | 5.5 | -3.0 |
| CPI (change in %, average) | 0.4 | 3.8 | 6.1 | 1.5 | 7.4 | 2.1 |
| Current account balance | -16.3 | -17.3 | -7.9 | -10.4 | -14.6 | -9.3 |
| FDI (% of current account) | 42.8 | 32.8 | 73.9 | 132.7 | 36.7 | 25.0 |
| General government balance | 1.6 | 2.9 | 2.4 | 1.3 | -1.5 | -4.0 |
| Reserve cover (months of import) | 3.7 | 4.0 | 5.2 | 5.4 | 4.4 | 5.5 |
| Gross external debt | 47.5 | 52.6 | 48.0 | 48.5 | 40.5 | 42.0 |
| Public debt | 25.5 | 25.6 | 21.2 | 18.1 | 14.6 | 16.0 |

*Source: BiH authorities, IMF.*

The real effective exchange rate has been quite stable and does not raise significant external stability concerns. Indicators of price and cost competitiveness vis-à-vis neighboring countries (being the most important trading partners) have been benign, while export growth has been remarkable over several years prior to the crisis. Constant-market-share analysis suggests that export growth between 2003 and 2006 can be mainly explained by the competitiveness effect. Relative to non-tradeables, average labor productivity of tradeables was much higher than that of main trading partners (euro area and neighboring countries).

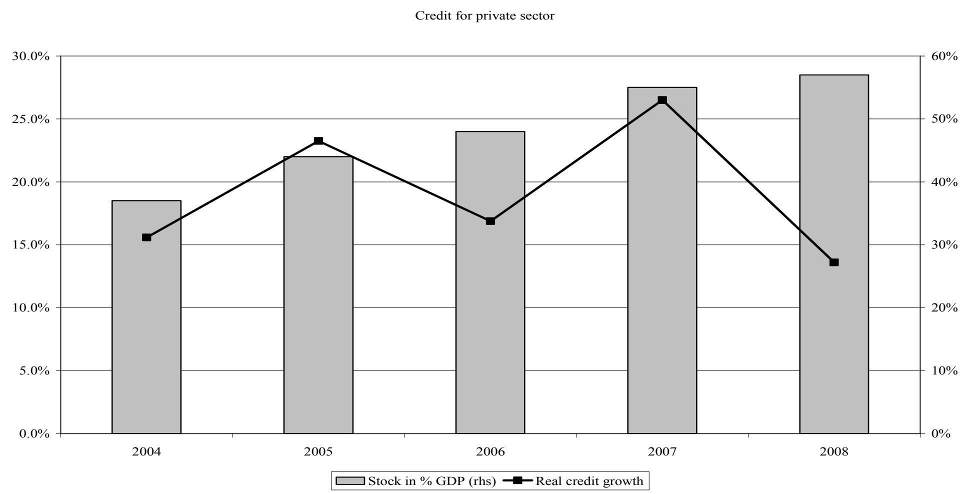
[3] Statistics on internal debt is still missing, so estimates of debt stock are necessary. Data have been quoted from IMF Article IV 2008.

After the period of fiscal consolidation, the fiscal position has deteriorated in the last two years as a result of pro-cyclical fiscal policy. The large increase in public spending started in 2006 in the context of the fiscal space created by the introduction of the value-added tax (VAT). The general government surplus of 1.3% of GDP in 2007 was much lower than the surplus of 3% of GDP in 2006, which will lead to a deficit larger then 2% of GDP in 2008. Fiscal consolidation prior to 2008 alleviated pressure on external imbalance. Also, fiscal consolidation has been necessary to create space for settlement for resolving of accumulated arrears and liabilities from the pre-war period. Driven mainly by sharp increases of transfers to households, capital spending and public wages, government expenditures reached 50% of GDP. Strong revenue performance has continued even in 2008, but a gradual slowdown is expected even without effects of the current economic crisis. Tax reforms encompassed direct taxation as well, corporate and personal income taxes were streamlined and simplified in order to broaden the tax base and reduce the tax burden for employers. Results of these tax reforms are still not fully reflected in economic growth, but their positive impact is to be recognized soon.

The monetary regime based on the currency board with the peg to the euro has been successful in keeping inflation low. Inflation has been only slightly higher then in the euro area with the only exception in 2006. Due to a one-time price adjustment after introduction of the VAT, annual inflation in 2006 was substantially higher than in the previous years, but it proved not to have a prolonged effect. However, inflation dynamics abruptly changed in 2008, when inflation peaked at 9,9% in July due to an enormous increase of world energy and food prices. The nominal growth of wages has been much higher than inflation, so real wage growth was significant (10% in March 2009). Such a wage growth was partially underpinned with an increase of productivity in manufacturing, finances and the tradable sector. But wage pressure from the public has mounted in the recent period, after the government raised public wages to levels sometimes even higher than in the private sector.

Rapid financial deepening has been a key growth contributor and has been continuing for several years. After successful privatization and massive capital inflows in the banking sector credit flows have been very intensive in response to high demand from the private sector. Foreign-owned banks dominate the banking sector and liquidity management and financing is mostly managed through relation between local subsidiaries and foreign parent companies. Real credit growth for the period 2004–2008 averaged 19%, which led to an increase of the private credit stock to 57% of GDP at the end of 2008. Prolonged rapid credit expansion raised concerns about the widening current account deficit and about possible uncontrolled accumulation of credit risk by banks. Although the credit level was very low at the very beginning and credit expansion was understandable, it has become clear that such expansion may have negative macroeconomic consequences over time. The central bank was prompted to tighten reserve requirements in order to slow down credit growth. The last increase of the reserve requirement rate from 15% to 18% was introduced at the end of 2007. Simultaneously, supervision authorities introduced additional prudential measures with the aim for more reliance on domestic funding instead of foreign borrowing by banks. However, the effects of these measures have been limited in circumstances of high liquidity in the international markets and increased demand for loans.

*Chart 1: Credit for the Private Sector (2004 – 2008)*




*Source: CBBH statistics.*

Banking supervisory activities have been focused on controls of both compliance with prudential regulations and business and financial operations on bank-by-bank basis. Supervision framework is still based on Basel I principles. Banking sector has grown steadily without any major banking crisis (only problematic banks are two insolvent banks without any active participation in the market) and need for fiscal remedies. Recently, more emphasis was given to the financial stability issues and systemic analysis of the banking sector. The central bank and supervisory authorities have been engaged in intensive coordination with the aim to ensure financial stability of the whole system. Cross-border supervisory cooperation has not been very effective, despite several bilateral and multilateral Memorandums of Understanding on supervisory co-operation. Some of the foreign supervisors have not been keen to establish effective co-operation and domestic supervisors have been deprived from access to key information about parent-banks consolidated balance sheet data and relevant supervisory assessment.

# 2. Crisis Impact and Untested Resilience

Over the first three quarters of 2008, real sector developments evolved pretty much according to the predicted scenario with a gradual slowdown in economic activities. However, the worsening of the financial crisis in September and October brought this benign scenario to an abrupt end. Industrial production and exports decelerated significantly in November and December, with a particularly pronounced decline in the base metal and the automobile industry. This deterioration of economic trends continued in the first quarter of 2009 and the output forecast has been drastically cut to around minus 2% for 2009. Thanks to a restart of large oil processing facilities industrial production is still growing, but almost all other industries declined by at least 15% to the first quarter of 2008. The export sectors have been suffering from weak metal[4] prices and import demand in the EU and CEFTA countries. For instance, aluminum prices fell nearly 40% from their peak in summer 2008 and prices of some steel products fell 30%. Moreover, EU import growth is projected to almost half in 2009 from 7% to 4%. The construction sector, except few large public infrastructures, is directly hit by the credit crunch, which will affect the demand for new business and residential buildings, as well as the ability to finance new projects. Finally, the retail sector has been affected by the slowdown of export earnings, reduced access to credit and reduced confidence on the side of consumers, so retail sales were down 10% in the first quarter to the same period last year.

*Chart 2: Export Performance*


*Source: BiH Agency for Statistics.*

[4] Base metals export account for around 30% of total export.

The external imbalance is likely to moderate in 2009 as a consequence of weaker domestic demand. Hence the current account deficit (CAD) will be bellow 10% of GDP, which is much lower than in previous years. The anticipated reduction of CAD is also the result of a substantial drop in oil, food, but also base metals prices, which together comprised around 44% of BH imports in 2008. The sources of CAD financing are more uncertain than previously. In 2008, less than half of the CAD was financed by FDI (5.7% of GDP), and another 10 to 12% by capital grants and drawings of loans by the government. Thus, about 40% of CAD depended on foreign borrowing by commercial banks and to a lesser extent private companies. In 2009, the FDI inflow is likely to decline relatively to previous years. (IMF WEO reports dramatic drop of 116% in capital inflows in the CEE) Moreover, the private sector is finding it increasingly difficult to borrow from abroad. Consequently, a larger portion of CAD financing may put pressure on foreign exchange reserves, which suffered a loss of 15% since October. The current level of foreign exchange reserves would be adequate to absorb this kind of shock in 2009, but there are realistic expectations that international financial institutions will provide additional financial assistance (Stand-by arrangement with the IMF has been recently discussed and other IFIs will likely make available additional sources for international reserves).

Inflation rates have been declining to 0.8% in March as a consequence of the slowdown in transport and food prices (drop of 3.5%). As the commodity prices and economic activity are on a downturn across the globe, BiH will not be importing inflation in 2009. Forecasted inflation in 2009 will be in the range of 2 to3% and depend on the price of goods and services provided by the public sector, public sector wage policy, and the aggregate level of public expenditures.

The first wave of the ongoing crisis hit the banking sector when depositors started to withdraw deposits from the banks in October, when KM 814 millions or 6.3% of total deposits were taken out of the banks. Although resident banks were stable and without any losses from the international financial crisis, households were alerted with events in other countries and market downgrades for large international banks. The episode did not last too long and confidence in banks was restored after two weeks. The central bank of Bosnia and Herzegovina (CBBH) reacted promptly and reduced the reserve requirement rate from 18% to 14% in order to provide additional liquidity and compensate the withdrawn deposits. Also, the government increased the threshold for insured deposits from EUR 3,250 to 10,000in early 2009. The CBBH continued with the relaxation of available monetary instruments, so reserve requirements have been further lowered to 10% for long-term liabilities (and 14% for short-term liabilities) and new foreign borrowings are totally exempted from the reserve requirements. Despite all these measures, credit flows to the private sector dropped significantly in the beginning of 2009. (private sector credit growth was only 12.7% in March compared with 26.9 % in September 2008), while lending rates increased significantly. Foreign subsidiaries have been facing a lack of foreign funding, since these banking groups are in a deleveraging process and can not provide much funding for their subsidiaries. Profitability of the banking sector for 2008 strongly deteriorated compared to 2007 (total profits are 43% lower and main profitability indicators declined accordingly), and even worse results are expected in 2009.

*Chart 3: Rapid Credit Slowdown after Break-up of the Crisis*


*Source: CBBH statistics.*

In the current global downturn the banking sector is likely to face a further deterioration and shocks on both sides of its balance sheet. In this environment, enhancing crisis preparedness and improving monitoring are key priorities. Various authorities will work jointly on contingency planning arrangements and prepare for various crises scenarios. To this end, the creation of a Standing Committee for Financial Stability (comprising of fiscal authorities, banking agencies, deposit insurance agency, CBBH) has been under discussion. Its main task would be to review crisis preparedness and to discuss individual cases of significance and other developments relevant to financial stability.

The fiscal position has been very strained after the crisis started. The robust growth of tax revenue that was seen in recent years will not continue in 2009. The tax revenue will probably decline in nominal terms and also as percentage of GDP due to decreasing domestic demand and lower domestic and import prices. Under such circumstance, consolidated expenditures would need radical adjustment in order to run tolerable fiscal deficit (up to 4% GDP) in 2009. Authorities are keen to reduce current public consumption (especially public wages and social transfers) and continue necessary public investment. Even without any a fiscal expansion (such as a fiscal stimulus or bank bail-outs), the level of public debt is likely to grow as a result of the economic crisis.

## 3. A Need for Structural Changes and Different Growth Patterns

The existing monetary and exchange rate regime will be the cornerstone of future economic policies. The Currency Board Arrangement has served well over the past 12 years, ensured macroeconomic stability with low inflation, and has broad political and public support. The conservative financial system embedded in the currency board arrangement proved very beneficial as the financial crisis evolved and many other countries with more sophisticated countries were engulfed in credit problems, partly as a result of loose monetary policy. One of the main tasks for the next period is to secure the stability of the financial system. It would require further improvement of banking supervision, especially cross-border cooperation and approximation with the euro zone regulation and innovation. Also contingency planning and monitoring need to be further developed to ensure prompt and adequate reaction in the case of emergency. As it is likely that real sector circumstances deteriorate, banks will face further problems with asset quality.

Some of the main trading partners of BiH have recently experienced sizeable exchange rate deprecation, which might have an adverse impact on our competitiveness. It will necessitate to implement tools to prevent real appreciation of domestic currency. Wage flexibility needs to be maintained, and the government is determined to have a strict wage policy over the next 3 years. It is expected that wage restraint in the public sector will provide a strong signal for wage moderation in private sector settlements. Wages have been mostly negotiated at company level, which will facilitate necessary downward adjustment. However, some regulations of the labor market still need to be reformed in order to ensure more flexibility for employers (like part-time jobs, severance payment, …)

The current fiscal position has been very tight and does not provide space to finance fiscal stimulus from domestic sources. Ongoing reshuffling of public expenditures have been designed to reduce current consumption, without any increase in capital investment. It is, therefore, necessary to rely on external sources of capital for the stimulus aimed to boost domestic demand. Efforts should be made to secure additional funding for more projects from IFIs and foreign governments, since the access to international markets is severely constrained due to the low sovereign credit rating and increased risk aversion of foreign investors. After the worst part of the crisis is over, there is an urgency to ensure medium and long term fiscal sustainability. The level of public debt will rise over the next 2 to3 years, but it would require undertaking very bold steps to gradually reduce the debt level after the crisis is over. Future accession to the EU would impose strict rules on fiscal position and fiscal policies need to take it into account well before actual joining the EU. The limited room for fiscal maneuver underlines the importance to undertake the most effective measures including an increase in spending efficiency by e.g. cutting public administration costs, urging state-owned enterprises to devise saving plans or reducing the rate of public sector wage increases and pensions. At the same time, public sector salaries and social benefits should not be presented as mandatory budgetary items. Only debt payments are mandatory items and even they could be postponed, although it would not be wise to suggest that at the moment. Increases in public sector salaries and social benefits are the consequence of long-term pressures from certain interested groups and future fiscal sustainability should be saved at any cost. So, the government should cut its current expenses on a more permanent basis and avoid temporary reduction (especially wages and social transfers).

Current government interventions are mainly aimed at preserving jobs and tempering output loss. To this end, governments have prepared, after a certain delay, a comprehensive action plan, but efficiency of these actions is still very limited. The main problems are a lack of fiscal space for massive interventions (subsidies, guarantees, capital injections and recapitalization) and complexity of structural reforms, which normally take a long time to complete.

Economic downturns are usually in times when existing economic policies and structure are being revised and new reforms are introduced. BH needs to prepare its economy for the post crisis resurgence and acceleration of European integration through tackling complex reforms. Governments and enterprises need accelerated economic reforms and increase efficiency to become more internationally competitive and able to achieve faster real convergence. Progress on structural reforms is uneven. BiH trails its best-performing peers on most structural and transition indicators and transition.

Private sector (still well below 60% of the economy) development has been hampered with burdensome regulations and weak institutions. Several international analyses[5] suggest that some of the reforms for more conducive business environment are important. The ongoing crisis will be an opportunity to address these deficiencies, which were frequently neglected during the periods of economic prosperity. It would enable to attract more foreign investments (which will be more difficult in the coming years) and to increase economic efficiency and lower production costs.

[5] Doing Business by the World Bank, EBRD transition indicators, Global Competetive Index, Corruption Perception Index

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