Conference: "The Western Balkans: 15 Years of Economic Transition"

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The International Monetary Fund (IMF) and the Oesterreichische Nationalbank (OeNB), in cooperation with the Joint Vienna Institute (JVI), hosted a conference in Vienna on March 10, 2015, marking 15 years of economic transition in the Western Balkan countries.[1] Following on the heels of the IMF's presentation of its recently published Regional Economic Issues Special Report on the Western Balkans[2] by *Aasim Husain,* Deputy Director in the European Department of the IMF, the conference also delivered a platform for ministers and central bank governors of the region to exchange their views on economic policy issues.

Growth convergence and inclusiveness

The first session dealt with issues of growth convergence and inclusiveness. It was chaired by *Aasim Husain* and opened by *Ivanna Vladkova Hollar* (both IMF), who discussed factors that have affected the speed of convergence of the Western Balkan countries. Hollar explained that the region has improved living standards and increased income levels after the dislocations of the 1990s. However, the pace of convergence toward EU levels has been slower than in the CESEE EU Member States and has stalled since the onset of the crisis at per capita income levels of less than one-third of the EU average. From 2000 to 2011, capital accumulation and growth of total factor productivity contributed to GDP growth, while increases in labor input were negligible as a growth driver. Hollar showed that unemployment rates are very high and activity rates are low in comparison to the new EU Member States or the EU-17.[3] She argued that a relatively low FDI stock per capita has held back job creation in the Western Balkan countries. In contrast, the new EU Member States have been able to attract larger amounts of FDI and consequently face considerably lower unemployment rates. Hollar argued that weak labor market outcomes in the Western Balkans are also the result of comparatively low rankings in global competitiveness as measured by indicators such as the share of women in the labor force and the flexibility of wage determination. She concluded by saying that not only macroeconomic developments are important for improving the labor market situation of the Western Balkan countries, but that also structural reforms are decisive.

The next speaker, *Gallina Vincelette* (World Bank), focused on drivers of economic growth, the pace of convergence, and progress in inclusive and sustainable economic growth in the Western Balkan countries. According to Vincelette, economic growth can be considered as a key driver of poverty reduction. While the pre-crisis years in the Western Balkans still saw stable economic growth, the countries are now facing a rather challenging situation with low GDP growth, high unemployment rates and weaker inflow of remittances. Households in the Western Balkans to a large extent depend on transfers (remittances, other private transfers or public transfers) and show weak attachment to the labor market.

[1] *The term "Western Balkans" covers the following seven countries: Albania, Bosnia and Herzegovina, Croatia, Kosovo, FYR Macedonia, Montenegro and Serbia.*

[2] *See http://www.imf.org/external/pubs/ft/reo/2015/eur/eng/pdf/erei_sr_030915.pdf.*

[3] *The term "EU-17" covers the following countries of the European Union: Austria, Belgium, Cyprus, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, Netherlands, Portugal, Spain, Sweden and the United Kingdom.*

Especially young people, women and minorities are often excluded from the labor market. Vincelette also pointed out that public transfers are very high in Western Balkan countries, but often poorly targeted. The presenter proposed several measures for sustainable economic growth and the creation of jobs in the region: maintaining macroeconomic stability, improving the quality of the investment and governance environment, eliminating disincentives and barriers to jobs, enhancing the efficiency of public services and infrastructure, improving the targeting and coverage of social protection systems and, finally, using natural resources in a sustainable way.

Isabella Moder (OeNB) discussed to what extent the business cycles of the Western Balkan economies are synchronized with the euro area and explained the factors that drive business cycle convergence between the two regions.[4] Western Balkan countries have limited or no scope at all for independent monetary policy. Against this background the degree of business cycle synchronization is relevant for evaluating the costs of lacking independent monetary policy. The presenter showed that business cycle synchronization vis-à-vis the euro area is high for Bosnia and Herzegovina, Croatia, FYR Macedonia and Montenegro, whereas progress in that area has been more gradual in Albania, Kosovo and Serbia. Generally speaking, business cycle synchronization has increased over time. Only during the peak of the financial crisis in 2009, an interruption was observable. Moder also found that bilateral trade and fiscal policy – used as an anticyclical stabilization instrument – support business cycle convergence, while FDI inflows and remittances seem to have a dampening effect on it. She concluded that, in terms of business cycle synchronization, the lack of independent monetary policy seems not to be very costly at the current stage. However, she cautioned that business cycle synchronization is only one aspect of an optimal currency area and that other aspects are also important.

Macroeconomic and structural policies

The second session, chaired by *Ellen Goldstein* (World Bank), addressed the issue of macroeconomic and structural policy. *Zuzana Murgasova* (IMF) provided an overview of the key macroeconomic challenges in the Western Balkan countries. She focused on external imbalances in the region. Current account deficits are very high when compared with the new EU Member States. She argued that current account deficits are largely driven by huge trade deficits reflecting weak competitiveness and low export ratios. Furthermore, FDI inflows are largely directed toward the nontradable sectors and not to the tradable sector. With regard to public finances, most Western Balkan countries have experienced some deterioration of their fiscal position since the onset of the financial crisis, and fiscal consolidation is needed in many countries. On the positive side, the Western Balkan countries have successfully reduced inflation but now are facing new challenges because inflation rates are very low or even have reached negative territory in several Western Balkan countries. Finally, Murgasova showed that the applied exchange rate regime seems to be irrelevant for inflation.

[4] *The presentation was based on joint work with Antje Hildebrandt (OeNB).*

Peter Sanfey (European Bank for Reconstruction and Development – EBRD) elaborated on the inherited structural challenges of the Western Balkan countries at the start of the transition process and described how the region has progressed in terms of structural reforms since 2000. He analyzed the well-known EBRD transition indicators. In 1989, it seems that Western Balkan countries (excluding Albania) were in a better starting position than some of the new EU Member States. However, one has to be careful when analyzing the indicators. In former Yugoslavia, for example, some liberalization and privatization had been undertaken by 1990 but effective privatization and better governance was often thwarted by social ownership. A comparison of intraregional trade among the Western Balkan countries and among the new EU Member States (excluding Bulgaria, Croatia and Romania) shows that there is much scope for improving trade linkages among the Western Balkan countries. Sanfey provided evidence from the Life in Transition Survey by the EBRD and World Bank that nostalgia for the past has made reforms more difficult in the Western Balkans. Furthermore, a large share of people in the Western Balkans believe that political connections and patronage are important for getting ahead in life. Despite these negative aspects, reforms have advanced since 2000 in the Western Balkan countries but the region still lags behind the new EU Member States.

Maksym Ivanyna (JVI), in a joint study with *Norbert Funke* (JVI), analyzed how Western Balkan countries compare to CESEE EU Member States in terms of structural reform progress and proposed reform priorities both at the regional and country level. Reforms are decisive for economic growth but some reforms have a stronger impact on economic performance than others. Ivanyna analyzed reform gaps in combination with growth regressions. Compared to CESEE EU Member States the reform potential and need is still large; most reforms are of high priority. Reforms of institutions, investments in infrastructure, financial market development and goods market efficiency are important in at least five of the six countries. Progress in labor market efficiency and education are also critical.

Financial sector development and stability

The third session focused on financial sector development and stability and was chaired by *Doris Ritzberger-Grünwald,* Director of the Economic Analysis and Research Department of the OeNB. *Nadeem Ilahi,* Deputy Division Chief in the European Department of the IMF, presented the Special Report results on financial deepening, banking sector resilience and challenges to financial sector development. The Western Balkans' banking sector has been substantially transformed by foreign investment and know-how, which has facilitated a more efficient allocation of capital. Starting in the early 2000s, foreign investment into banking combined with increased deposit bases boosted private sector credit. As a result, bank deposits and bank credit to the private sector increased by a cumulative 30% of GDP between 2002 and 2012. In fact, financial sectors in the Western Balkans have deepened more than those in the CESEE EU Member States at comparable stages of transition. Nevertheless, overall financial depth is fairly low, particularly in the nonbank financial sector, mirroring still lower levels of income and development. Some Western Balkan countries do not even have a stock market. In the years leading up to the global financial crisis, the increase in capital flowing into the Western Balkans was as significant as that into CESEE EU Member States.

The resulting extension of credit via bank intermediation went beyond what fundamentals would have warranted – similar to the experience in other emerging European economies. Interestingly, the post-crisis credit bust has been milder and the share of nonperforming loans (NPLs) rose significantly less in the Western Balkan countries than in CESEE EU Member States following the global financial crisis. The IMF attributes this different experience to the fact that the inflows into the banking system of the Western Balkan countries largely stemmed from FDI and equity investment rather than borrowing from parent banks and wholesale funding markets. However, while NPLs have started to come down in the CESEE EU Member States, in the Western Balkans they remain at post-crisis peaks, and in some countries they are still increasing. Hence NPLs will continue to weigh on bank profitability and credit growth if left unresolved. Tackling this problem will require better collateral enforcement, improved insolvency frameworks and the clearing of bottlenecks in overloaded court systems. In addition to reforms to strengthen the supervision and regulation of financial institutions, the development of nonbank financial markets would help diversify sources of funding.

Johanna Jaeger (World Bank) presented research on financial inclusion, i.e. the extent of access to banking services for households and firms. Throughout the Western Balkans, households' access to finance remains comparably low by Western European standards, in particular the access of poor households and women is constrained. Low levels of saving via formal channels can be partly explained by a lack of trust in financial institutions and low financial literacy. But also for enterprises, constrained access to financial services, in particular credit, remains a key obstacle to business growth. World Bank survey data confirm a strong dependence on internal funds for financing investment. Policy responses should therefore address information asymmetries, weaknesses in NPL resolution and collateral utilization, as well as the provision of new financing sources and products, and the strengthening of financial education.

Elisabeth Beckmann (OeNB) discussed the relative importance of demand and supply factors in explaining the high incidence of foreign currency borrowing by Western Balkan households. Research based on microdata from the OeNB Euro Survey confirms that households' foreign currency loan demand is driven by interest rate differentials, a lack of trust in the stability of the local currency, exchange rate volatility, a lack of knowledge of exchange rate risk, the widespread usage of euro cash and a preference for foreign currency deposits. Moreover, results indicate that most borrowers have had the chance to choose the loan currency. On the other hand, the actual incidence of foreign currency loans is higher than suggested by demand. This indicates that banks also play a role in foreign currency lending dynamics. Interestingly, Elisabeth Beckmann and her coauthors Anita Roitner and Helmut Stix do not find a significant difference between domestically and foreign-owned banks with regard to loan currencies, neither for consumption loans nor for mortgages. Finally, their econometric analysis based on microdata shows that high and increasing NPLs of households in Western Balkan countries can only be partly explained by foreign currency borrowing. Negative income shocks seem to be the most important determinant of households' arrears.

High-level panel discussion – policy challenges and solutions ahead

The conference concluded with a high-level panel discussion chaired by *Poul Thomsen* (IMF) and attended by Božidar Đjelić (Managing Director, Lazard), Ewald Nowotny (Governor, OeNB), Jeffrey Sachs (Director, Earth Institute, Columbia University), Zoran Stavreski (Minister of Finance, FYR Macedonia) and Boris Vujčić (Governor, Croatian National Bank). Discussants agreed that it is the incomplete nature of institutional and structural reforms undertaken and doubts about the EU integration perspective that is holding the region back. Without a courageous reform push, Western Balkan countries cannot expect to attract the scale of investment flows that is needed to finance faster and at the same time sustainable growth and to join the European Union, and they risk staying stuck at income levels that are less than one-third of those observed in Western Europe. *Božidar Đjelić* stressed that economic reform must encompass political reforms as well, fostering democracy and entrepreneurship and pushing back vested interests. Governor *Ewald Nowonty* recommended holding on to the perspective of EU membership. Institutional and structural reforms are beneficial for the Western Balkans beyond the envisaged EU membership. Governor *Boris Vujčić* argued that postponing structural reforms implies a more disadvantageous position in the future and thus even more efforts to catch up. Western Balkan countries can learn a lot from the experience of fellow CEE economies and leapfrog in their development if they dare to "think big." Similarly, Minister *Zoran Stavreski* advised policymakers to be committed to the reform agenda and not give in to vested interests. Otherwise one risks missing the major promises of the transformation and catching-up process. *Jeffrey Sachs* elaborated on the economically unfavorable historical and institutional legacies and some geopolitical aspects of the economic development in the Western Balkans. He emphasized the need to intensify efforts for a speedy EU enlargement and encouraged fostering intraregional cooperation with respect to investing in infrastructure and accessing new markets in neighbor regions.