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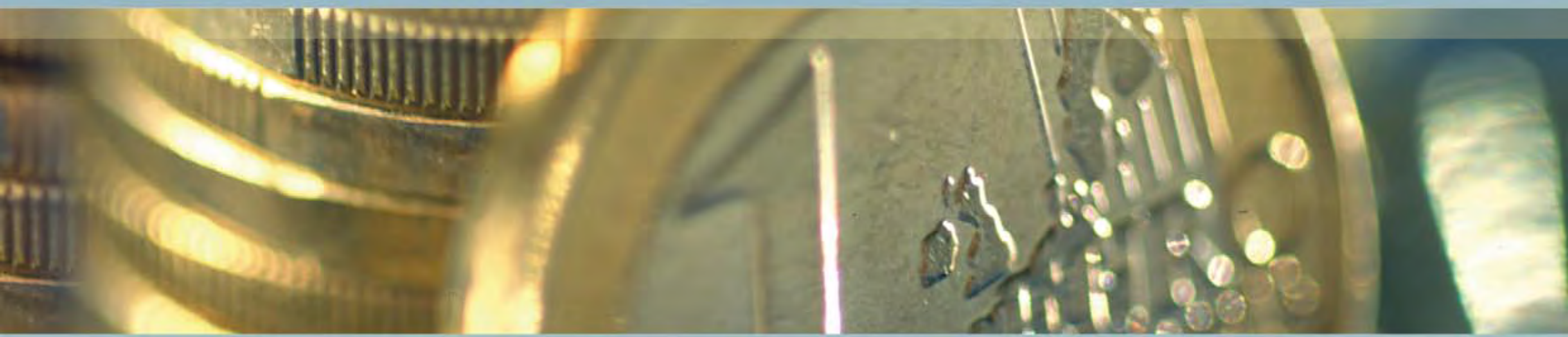

The pre-accession economies in the global crisis: from exogenous to endogenous growth?

Directorate-General for Economic and Financial Affairs

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FOREWORD

The international financial crisis that broke out in 2007 affected a number of EU pre-accession countries already in the first half of 2008 and spread to most of the region after the bankruptcy of Lehman Brothers in September 2008. Not being members of the EU, pre-accession countries appeared ex-ante more vulnerable and exposed to the crisis than new EU Member States. However, notwithstanding their vulnerabilities, and fears that they could suffer deeply in the global deleveraging process, pre-accession countries demonstrated a high degree of resilience to the financial turmoil. While the crisis took a heavy toll on growth, they were broadly able to withstand pressure and successfully avoid worst-case meltdown scenarios.

This publication covers Turkey and the candidate and potential candidate countries in the Western Balkans. DG ECFIN staff already examined the first developments of the crisis in pre-accession countries in a number of recent publications in 2009 ([1]) and early 2010 ([2]), pointing to the high degree of exposure to the crisis of the pre-accession countries – particularly the Western Balkans – in view of their large external deficits prior to 2008 and hence their reliance on foreign capital to finance their growth. It was obvious that the limited room for manoeuvre offered by the macro-economic policy mix – both on the monetary and the fiscal policy side – in most of the pre-accession countries would not allow the kind of full fledged crisis response policies that have been pursued in the EU. As global liquidity dried out in 2008, the region's growth engine appeared dramatically challenged, with fears that a possible "sudden stop" of capital inflows could trigger a very severe macro-economic adjustment and jeopardise macro-financial stability.

The present publication attempts to gain a more in-depth understanding of the main structural vulnerabilities of the pre-accession countries and, with the benefit of the experience of developments throughout 2009, the main channels of development of the crisis, policy response attempts to weather its effects, and finally some of the challenges for the years ahead. While long-term convergence with EU wealth levels remains a legitimate objective, a new and more sustainable growth model – relying less on external capital inflows to finance growth, but more on intrinsic competitiveness of their economies – may have to emerge as pre-accession countries exit the crisis. It needs to be underlined that the low quality of economic data in many countries of the region has sometimes hampered the analysis.

This publication was co-authored by staff from the unit in DG ECFIN in charge of the economies of candidate and potential candidate countries under the guidance of Carole Garnier and Christophe Pavret de la Rochefordière. The editorial team was composed of Plamen Kaloyanchev, Mihai Macovei and Ulrich Windischbauer. Additionally, contributions came from Bernhard Böhm, Ivan Ebejer, Antonio Sánchez Pareja, Uwe Stamm and Dirk Verbeken. The authors are grateful for comments received from Bernhard Funck and his colleagues (World Bank), Peter Sanfey (EBRD), Albert Jäger and his colleagues (IMF), Max Watson (Wolfson College, Oxford, and Centre of Excellence and Finance, Ljubljana) and Johan Baras (DG ECFIN) and for valuable preparatory work done by Milan Aleksić (National Bank of Serbia) during his internship in the unit. The authors would also like to thank Anders Lindqvist for his statistical support and Anna Schmidt for her editorial assistance.

The views expressed are the authors' alone and do not necessarily correspond to those of the European Commission.

([1]) See in particular:
"The Western Balkans, European Economy. Occasional Papers. 46. May 2009, available at http://ec.europa.eu/economy_finance/publications/publication_summary15159_en.htm and
"Growth and economic crises in Turkey: leaving behind a turbulent past? by Mihai Macovei, European Economy. Economic Papers. 386. October 2009, available at http://ec.europa.eu/economy_finance/publications/publication_summary16002_en.htm.

([2]) "EU Candidate and Pre-Accession Countries Quarterly", latest issue 9 April 2010, available at: http://ec.europa.eu/economy_finance/db_indicators/cpaceq/index_en.htm.

EXECUTIVE SUMMARY

The good economic performance of the pre-accession economies before the crisis occurred against the background of a booming global economy. Easy access to international finance and ample liquidity world-wide spurred global economic activity, international capital flows and excessive risk taking.

The pre-accession countries achieved high growth rates between 2002 and 2007, driven in particular by strong investment growth and buoyant consumption in some countries. However, the convergence process was slower than might have been expected when taking into account the relatively low income levels in these countries and the performance of comparable new EU Member States. Turkey's economy expanded the fastest, while the former Yugoslav Republic of Macedonia and Kosovo ([3]) were clearly lagging behind the group.

The economic crisis has affected, to a different degree, all pre-accession economies with a lag of at least one quarter after the major EU economies. The initial correction started not through the external trade channel but via domestic demand, which contracted due to a build-up of precautionary savings and a correction of excesses in some sectors. The economic downturn was further deepened by a sudden and sharp contraction of external demand, starting in the fourth quarter of 2008. Croatia, Turkey and Serbia, which are more integrated in the global production chain, were impacted most heavily as the crisis was increasingly imported into the region through the trade channel. Montenegro, in view of its external accounts adjustment and the vulnerability of its small, non-diversified economy, was also severely hit by the crisis.

In terms of growth composition, it appears that the sustainability of the pre-crisis growth pattern was challenged by the large share of private consumption in GDP, which grew further in the boom years in some of the pre-accession countries. Moreover, investments in the region were geared more to the non-tradable sectors, in particular financial intermediation and real estate. The manufacturing sector reduced its contribution to value added in the economy, while the construction and retail trade sectors have continued their steady upward trend.

The pre-crisis growth performance was accompanied by large and widening external imbalances, although there are significant differences between the pre-accession economies. The widening of current account deficits resulted both from a steady increase in investment and, in some countries, from a significant decline in the savings ratio. The 2008 average savings level of close to 10% of GDP is only half that of the new Member States and does not provide a sound basis for sustainable capital accumulation and catching-up in the region. Growing external imbalances were mainly fed by increasingly negative private sector savings and investment balances. From the beginning of the crisis until mid-2009, the current account deficits receded significantly in the pre-accession countries as capital inflows dwindled and imports declined more than exports.

Despite substantial current account deficits, all pre-accession economies managed to accumulate what were – in some cases – sizeable official reserves, indicating that net capital inflows have been quite substantial in the pre-crisis period. The cumulative financial account surplus during 2002-2007 ranged from 18% of GDP in Kosovo to almost 60% of GDP in Bosnia and Herzegovina. Moreover, during this period, net foreign direct investments (FDI) financed on average almost three quarters of the current account deficits. The crisis has not led to a sudden stop in external financing, which continued to flow to the region, although at significantly lower levels. After a decline in 2008, official reserves stabilised at close to their pre-crisis levels in most countries in 2009 or even showed significant increases in some countries, such as Serbia.

The rapid expansion of the financial sector in the pre-crisis period – albeit starting from a low level in the early years of the decade – represented the main channel for the growing imbalances in the pre-accession economies. The period 2002-2007 saw a constant expansion of domestic credit in all economies, while credit to households increased at a faster pace than the credit to nonfinancial corporations. The banking sector's net foreign assets declined as credit growth was increasingly fuelled by foreign borrowing. Nonetheless, most of

([3]) Here and throughout the text, Kosovo refers to Kosovo under United Nations Security Council Resolution 1244.

the countries entered the crisis with relatively healthy, well capitalised banking sectors.

With the spread of the financial crisis and the decline in foreign capital inflows, lending decelerated sharply, but remained in positive territory in most pre-accession countries. "Mini-bank runs" occurred in Bosnia and Herzegovina, Montenegro and Serbia in October 2008, putting bank liquidity under stress. However, the situation improved relatively quickly as a result of the actions of the monetary authorities and eased further once the international liquidity crunch subsided in the spring of 2009. The quality of the banks' loan portfolio worsened as the economic contraction endangered the debt repayment capability of both enterprises and households. Non-performing loans (NPL) ratios rose in the region, particularly in Albania, Montenegro and Serbia, exposing the banking sector to a negative feedback loop from the real economy. Bank profitability declined significantly, with the notable exception of Turkey.

The monetary policies conducted prior to and during the crisis were in line with international policy reactions, albeit with differences from one country to another. Except for Turkey, monetary policy was constrained by the wide-spread exchange rate arrangements based on the euro and the high degree of euroisation. After some initial tightening in order to counter pressures on the exchange rate, policy reactions to the crisis were brought back into line with international developments, i.e. – lowering of policy rates, liquidity injection in the markets and easing conditions for lending and refinancing operations.

Remarkable fiscal consolidation achievements in the region – often fuelled by cyclical tax revenue buoyancy on the back of large absorption booms in 2002-2005 – had come to a halt and even had been reversed in the years 2006-2008. Despite overall limited public debt levels, fiscal expansion in the boom period increased the vulnerability and the exposure to the global financial crisis. Taken in conjunction with the wide-scale external deficits, this meant that most Western Balkan countries lacked the fiscal space and the proper prioritisation of public spending in order to pursue fiscal stimulus policies in response to the crisis. Except for Turkey, fiscal tightening measures involving numerous budget rebalances were implemented in the region, but this was not enough to prevent a widening of the fiscal deficits. Serbia and Bosnia and Herzegovina even had to resort to IMF/EU support in order to weather the fall in revenues in the crisis.

There is growing consensus to the effect that a moderate recovery is due to take place in the region in 2010, following the growth pattern of the main trading partner, Europe. In the near term, the stimulating effect of the external factors that drove the rapid growth in the pre-crisis period is likely to be less pronounced. As a result, the overall growth dynamics will probably be lower than in the past 5-7 years. Countries will have to rely more on endogenous growth factors, and competition for external funds might become tougher.

Real convergence in the pre-crisis period displayed several short-comings that were partly embedded in the unhealthy growth patterns of the global economic boom. The low level of domestic savings recorded in the majority of the pre-accession countries implied a growth pattern that was dependent on foreign savings and external capital inflows, and vulnerable to sudden reversals. The labour factor contributed only marginally to growth, which is indicative of a structural problem. Capital accumulation accelerated during 2000-2008, but the pre-accession economies are still lagging behind the fast growing economies in the EU or East Asia. Although picking-up, FDI was mostly associated with the protracted privatisation process rather than green-field investments. This can be overcome by adopting a new growth paradigm that would foster more rapid, sustainable growth. Several mutually reinforcing policy channels can be used in the area of structural reform, fiscal policy and monetary and financial regulation in order to increase the productive capacity of the economies. The acceleration of labour market reforms is of particular importance, given the insufficient contribution of labour input to growth.

CONTENT

LIST OF TABLES

LIST OF GRAPHS

LIST OF BOXES

1. RECENT GROWTH PATTERNS IN PRE-ACCESSION COUNTRIES

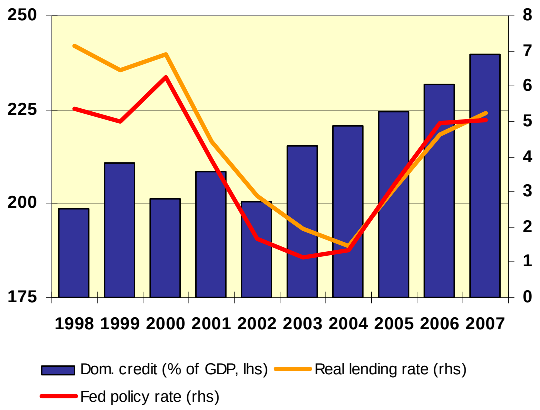
A brief review of the composition and determinants of growth in the pre-accession countries will provide a sustainability assessment of the pre-crisis growth dynamics and model. The improved growth and catching-up performance in recent years in the region has reflected a relatively high and fast-growing share of private consumption in GDP, fuelled by large inflows of foreign savings. In addition to domestic consumption-biased growth, capital accumulation tilted towards the non-tradable sectors, in particular financial intermediation and real estate, whereas the manufacturing sector developed proportionally less. Another important aspect relates to the relatively low share of green-field projects to the detriment of privatisation operations in FDI stock, which provides less impetus to the accumulation of capital.

1.1. INTERNATIONAL GROWTH TRENDS

To gain a better understanding of the economic performance of candidate and potential candidate countries it is useful to take a close look at the international economic context which has prevailed in recent years. The period 2003-2007 was marked by strong growth, not only in the pre-accession countries, but also on a world-wide scale. The boom in the global economy was triggered by long-term structural factors embedded in the globalisation process, but was also accompanied by a build up of major imbalances across the financial, housing and commodity markets. Several observers ([4]) noted that the widening of global imbalances and market booms reflected serious flaws in the operation of these markets, excessive risk-taking by financial institutions and inadequate regulatory frameworks, exacerbated by an excessively expansionary macroeconomic stance.

Success in the bringing down of inflation in the 1990s, helped by global productivity gains from integrating China and other labour-intensive emerging markets into world trade flows, facilitated the easing of monetary policy conditions in the advanced economies. After the dot-com bubble burst, policy rates were set well below the historical average, and below what the Taylor Rule ([5]) would have warranted, particularly in the United States and to a lesser extent in the Euro Area and Japan. Indeed, the historically low rates of the Federal Reserve System in 2002-2004 corresponded to very low real lending rates in the economy and a sustained growth of domestic credit and monetary aggregates. Earlier IMF analyses ([6]) also conceded the primary role played by monetary policy in driving nominal short- and long-term ([7]) bond yields well below historical averages. Some key emerging economies operated on fixed exchange rates with the US dollar, effectively importing the easy monetary stance.

Graph 1.1: U.S. interest rates



Source: Thomson- Reuters

In parallel with swelling monetary aggregates, there was also a widening of global imbalances with a significant increase (by almost five times) in international capital flows between 1999 and 2007. According to the WTO (2007) calculations, on average OECD surplus countries increased their current account balances from 2% of GDP in 1990

([4]) Among which the IMF, see IMF World Economic Outlook (October, 2008).

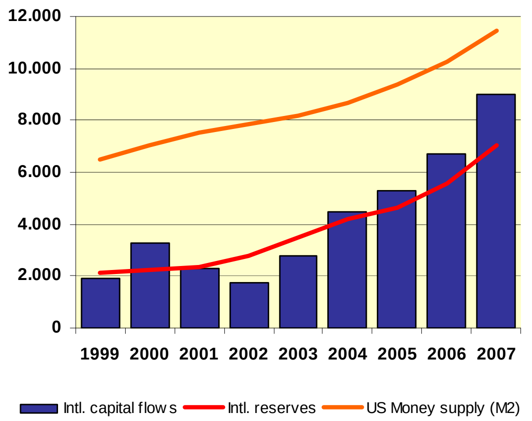
([5]) The Taylor Rule depends on the neutral real rate of interest (function of potential output growth), the deviation of expected CPI from target and the output gap.

([6]) IMF World Economic Outlook (April 2005).

([7]) As long-term rates reflect the expected future path of short-term rates (plus a liquidity premium), the slow pace of an anticipated monetary tightening helps keep long-term rates down.

to over 6% of GDP in 2006, with a mirror effect on typical deficit OECD economies. Similar developments took place in many developing countries, including the pre-accession countries.

Graph 1.2: **World capital flows and reserves, bn USD**

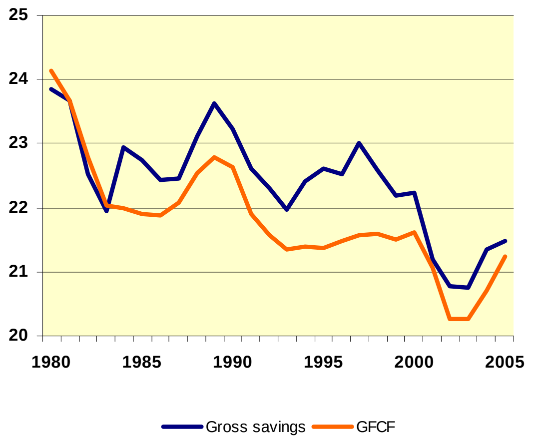


Source:
IMF, WEO April 2009, Reuters

Authors such as Bernanke (2005) and Daly and Broadbent (2009) stressed that the 'global savings glut', stemming mainly from soaring Asian savings, was the main driving force behind the global imbalances. However, it is debatable whether such a 'global savings glut' ever existed on a global scale, over and above regional 'pockets' of accrued savings in China, Japan or the oil exporting countries. In fact data on savings-to-investment ratios show that there has been a decline in global real savings since 1980. The gap between savings and investment ratios has also shrunk in the last decade. Thus, to attribute low real interest rates during this period to bloated real savings searching for scarce investment opportunities may not hold as a prime interpretation. Soaring savings in emerging economies may not have triggered the sub-prime mortgage crisis in the United States or the global financial crisis, as they continued to rise throughout both the boom and the bust in the housing market. ([8])

([8]) See Murphy (2008).

Graph 1.3: **World savings and investment, % GDP**



Source: Thomson- Reuters

At the same time, the strong liquidity impulse originating in American, European or Japanese banks appears to have fostered an international build-up of leverage and a global search for yield as well as the creation of risky assets and house-price bubbles in the United States and some other advanced economies. These developments reflect the findings of the Austrian theory of the business cycle, highlighting the central role played by an artificial credit expansion in the process. ([9]) Under normal market conditions, interest rates coordinate production across time. Lower interest rates need to reflect voluntary savings by the public resulting from lower consumption today in exchange for potentially higher consumption in the future. Low interest rates signal to businesses to invest more in long-term and capital-intensive projects. Consumer-goods industries, in turn, experience a relative contraction in response to the decreased demand and some of the previously employed factors of production are released to sustain investments in stages of the structure of production that are further removed from consumption. However, artificially depressed interest rates did not reflect consumers' time preferences or an increased pool of real savings in the economy. The increase in investments and their time-structure occurred when the demand for consumer goods had not slackened but rather was on the increase,

([9]) The theory was pioneered by Ludwig von Mises and F.A. von Hayek obtained the Economics Nobel Prize in 1974 primarily because of his contribution to it. The description of the theory is mainly drawn from Garrison (2002) and Woods (2009).

taking advantage of low interest rates and higher incomes. The economy found itself in a tug-of-war over resources between the stages of production closer to consumption and those further away from consumption. With resources unexpectedly scarce, the resulting rise in costs threatened the profitability and finalisation of long-term investments. One example is the building up of overcapacity in the housing and car sectors. Both sectors are sensitive to interest rate changes, given the large capital outlays needed to produce these goods, which are usually purchased by long-term credit. ([10]) Such a process appears to have taken place worldwide in recent years. According to the IMF, the global economy has been operating well above a cyclically neutral level (by comparison with the late 1990s) and real GDP grew at an average rate of 4.9% during 2004-2007. As the global economy both invested and consumed more, commodity prices rose to record levels ([11]) signalling a lack of real resources to sustain the expanded structure of the economy.

Overall, the accommodating US monetary policy stance would appear to have contributed to the housing boom and financial imbalances. ([12]) When monetary policy was tightened up again after 2005, the boom ended up in the financial crisis from mid-2007 and its subsequent recession. The ensuing economic contraction was not limited to the developed economies, but also spread rapidly to the emerging markets, where growth had been strong based on surging capital flows and better integration in the global division of labour. As the crisis hit in 2008, international capital flows to emerging and developing economies declined to only about 25% of the average recorded in the boom period 2003-2007. Together with the collapse of international trade flows, it has led to a significant slowdown of the economic activity of emerging economies in 2009.

The booming global economy also provided very favourable external conditions for the rapid growth of the pre-accession economies. In addition, strengthened EU accession prospects and the euro anchor reinforced investor confidence in the region. Overall, in line with international developments, the pre-accession economies recorded robust growth rates, large capital inflows, widening external deficits and a surge in investment and consumption during the good times. These underlying trends are substantiated in detail in the following chapters. As EU rapprochement and increased stability in the region overlapped with global economic expansion, it became difficult to disentangle the two processes and many analysts and decision makers took the accelerated economic catching-up and consumption smoothing for granted. However, as the global economy found itself in the corrective phase of the business cycle, the pre-accession countries jumped on the band-wagon, although at various speeds of adjustment.

1.2. GROWTH AND REAL CONVERGENCE IN THE REGION

During most of the last decade economic growth in the region strongly reflected the supportive international environment, but also the process of increased economic integration and legal and institutional alignment with the EU. However, as a result of the turbulent disintegration of former Yugoslavia ([13]), this process of increased international integration and economic reforms started nearly a decade later than it did in the new Member States. In most cases this period of relatively strong growth lasted from the beginning of the decade until 2007 and early 2008. In 2008 most of the economies in the region started to feel

([10]) It is estimated that the construction boom resulted in about 2.4 million redundant homes in the United States and around 1.2 million in Spain. The share of construction in GDP has currently dropped from a peak of above 6% in the US and 9% in Spain to around 2.5% and 5.5% respectively. See also French (2009) and Commerzbank (2010).

([11]) The oil price index increased more than four times between 1999 and 2008.

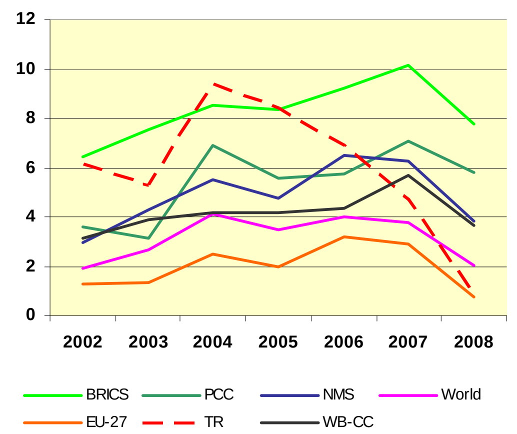
([12]) Using a FAVR model, Eickmeier and Hofmann (2009) found that monetary policy shocks contributed discernibly, but at a very late stage, to the unsustainable dynamics of house and credit markets observed during 2001 and 2006. As financial shocks influenced the path of policy rates prior to the crisis, the feedback effects of financial shocks via lower policy rates on property and credit markets has probably been considerable. ECFIN (2009) underlines that the crisis was preceded by a long period of rapid credit growth, low risk premiums, abundant availability of liquidity, strong leveraging, soaring asset prices and the development of bubbles in the real estate sector.

([13]) 1991 Independence and war in Slovenia
Independence of the former Yugoslav Republic of Macedonia,
1991-1995 Croatian war of independence
1992-1995 Bosnian war
1998-1999 Kosovo war
1999-2001 Southern Serbia conflict
2001 Macedonian conflict.

the impact of the global slowdown on their growth dynamics.

Compared to economic growth in other regions of the world, and in particular in the emerging economies, the economic performance of the pre-accession countries appears to be mixed. As can be seen in the following two charts, during 2003-2007 growth rates in most pre-accession countries were above global growth. During this period, global output growth accelerated from an annual increase of 2% at the beginning of the decade to around 4% between 2004 and 2007,([14]) while economic growth in the pre-accession countries was some 1-2 percentage points higher. However, a number of regions, in particular emerging economies such as Brazil, India, China and Singapore but also the Baltic countries, experienced significantly higher output growth from around 7% in 2002 to some 10% in 2007.

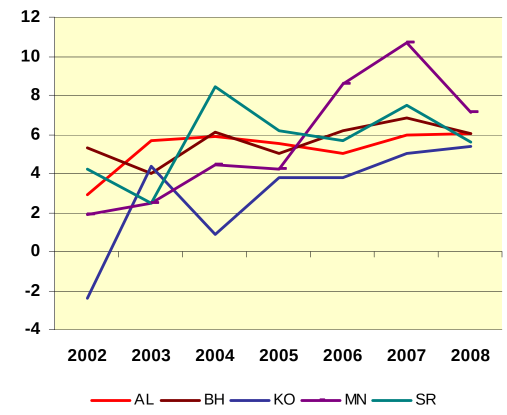
Graph 1.4: **Regional growth performance in international comparison**



Source: AMECO, THOMSON-REUTERS, World Bank: World development indicators, own calculations

The best performing pre-accession country was Turkey, with an average growth rate of nearly 7%, followed by the group of the potential candidates, with Montenegro and Serbia in particular registering impressive growth acceleration. Overall, the growth performance of the potential candidates was largely comparable to the average of the twelve new EU Member States. Growth in the former Yugoslav Republic of Macedonia remained relatively low, but also registered a significant acceleration during this period. In the case of Croatia growth appeared to have remained fairly stable, at some 5-6% per year.

Graph 1.5: **Growth of potential candidate countries (2002 -2008)**



Source: AMECO, THOMSON-REUTERS, World Bank: World development indicators, own calculations

At first sight this pattern of relatively strong growth in the pre-accession countries would seem to follow standard neo-classical theory, whereby economic integration will lead to absolute convergence, with less developed economies growing faster than more developed ones. As the following graph shows, most pre-accession countries did register growth rates beyond the EU-27 average, bringing per-capita GDP closer to the EU average. However, given their significantly lower income levels, at some 20-40% of the EU-27, one might have expected higher growth rates than those of many new Member States with higher income levels of some 60-80% of the EU-27 average. This would tend to confirm the prediction of the neo-classical model, namely that absolute convergence can only occur under certain conditions, in particular similarity in fundamentals.

([14]) Those growth rates do not take into account purchasing power parities. Calculations on the base of PPPs arrive at higher growth of global output, some 4.9% during 2004-2007.

Box 1.1: **Regional growth clusters**

When looking at a common growth pattern among countries in South-eastern Europe ([1]), a simple correlation analysis suggests the following findings: the economic dynamics of Romania, Turkey and Croatia shows no significant correlation with the remaining Western Balkan countries, while otherwise there appear to be two clusters with a similar growth pattern, a "northern" cluster, consisting of a highly correlated growth pattern between Bulgaria, and Serbia, but also significant correlation with growth in Bosnia and Herzegovina and Montenegro, and a "southern" cluster consisting of Albania, Kosovo and the former Yugoslav Republic of Macedonia. Furthermore, in 2002-2007, growth in Montenegro appears to have had significant correlation with Bosnia and Herzegovina and with the former Yugoslav Republic of Macedonia. This pattern largely reflects the spill-overs stemming from geographic proximity and the interactions between neighbouring countries. Exceptions are the low correlation of Croatian, Romanian and Greek growth dynamics with their Western Balkan neighbours.

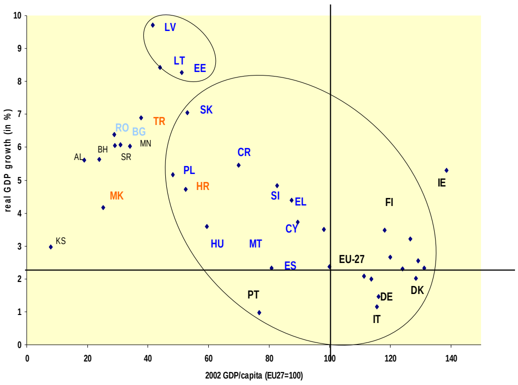
Correlation matrix - Average growth 2002- 2007

	BG	EL	RO	AL	BH	HR	KS	MK	MN	SR	TR
BG	1,0										
EL	-0,3	1,0									
RO	0,6	0,1	1,0								
AL	0,3	0,2	0,3	1,0							
BH	0,8	-0,2	0,6	0,2	1,0						
HR	-0,5	0,5	-0,2	-0,4	0,2	1,0					
KS	0,8	-0,1	0,4	0,7	0,6	-0,5	1,0				
MK	0,6	-0,1	0,3	0,8	0,6	-0,2	0,9	1,0			
ME	0,5	-0,1	0,4	0,4	0,8	0,2	0,7	0,8	1,0		
SR	0,9	-0,2	0,6	0,4	0,8	-0,3	0,7	0,7	0,5	1,0	
TR	0,6	0,0	0,3	0,1	0,0	-0,9	0,3	0,0	-0,3	0,5	1,0

Source: AMECO, ECOWIN, World Bank: World development indicators, own calculations

([1]) South-eastern Europe is this context refers to the Balkan as a whole (i.e. not only Western Balkan but also Bulgaria and Romania) plus Turkey.

Graph 1.6: **Real convergence (2002-2007)**



Source: AMECO, THOMSON-REUTERS, World Bank World development indicators, own calculations

At a country specific level, the performance of the pre-accession countries was slightly better than some of the 'average performing' new Member States, such as Poland and the Czech Republic, which are, however, already at a significantly higher level of per-capita income. The Baltic countries appear to have performed better, as has Slovakia. Bulgaria and Romania, countries where income levels tended to be lower than in some countries of the former Yugoslavia at the beginning of the decade, also clearly surpassed their neighbours in terms of per-capita income and convergence speed. This suggests that compared to their 'per-capita-income peers' among the new Member States, most pre-accession countries have lost ground. However, compared to the wealthier (old and new) Member States, the region appears to have caught up in terms of per-capita income.

A brief look at the demand components of GDP reveals the importance of private consumption and investment as the main sources of pre-crisis growth in the economies. As the following table shows, in practically all candidate and potential candidate countries, the rather strong growth during 2003-2007 was mainly driven by private consumption, but also to a large extent by investment and exports. However, given the significant share of private consumption in total GDP (about 80% in most of those economies, about 20 percentage points higher than in the new Member States), the dominance of this demand category is not so surprising. The exports of goods and services were close to or below 40% of GDP, while imports were higher than 50% of GDP, indicating substantial trade deficits in all countries. Not only was the overall demand structure tilted towards domestic demand, but also growth rates at the beginning of 2008 tended towards increasing this share even further.

In some countries such as Serbia, Turkey, Montenegro and the former Yugoslav Republic of Macedonia, the dominance of private consumption as the main source of growth is particularly striking. In Bosnia and Herzegovina, Croatia and particularly Albania, investment also played an important role for growth. Net-exports were negative in most cases.

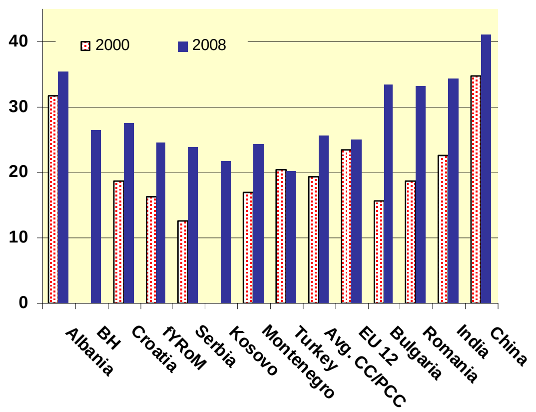
Table 1.1: Growth rates -5 year averages (2003-2007)

	AL	BH	HR	MK	SR	TR	Average
Private Consumption	2,4	2,1	4,4	6,0	7,9	7,8	5,1
Public Consumption	3,6	4,8	2,9	-3,9	0,4	4,1	2,0
Total Consumption	2,5	2,5	7,3	2,1	6,5	11,9	5,5
Gross Fixed Investment	27,7	12,7	10,1	6,8	22,8	15,0	15,9
Exports	8,8	12,0	6,3	4,0	17,1	8,0	9,3
Imports	13,5	4,1	-6,8	-5,1	15,4	-14,6	1,1
GDP	5,6	5,6	4,7	3,2	6,9	6,9	5,5

Source: Thomson-Reuters, own calculations

In terms of dynamics, in most countries, investment growth was by far the most rapidly increasing demand component, rising during the boom period by nearly 30% in Albania and by 23% in Serbia. Only in the former Yugoslav Republic of Macedonia have investment dynamics appeared to remain rather weak.

Graph 1.7: Gross fixed capital formation, % GDP



Source: National sources

These strong dynamics have led to a marked increase of investment-to-GDP ratios. However, compared to some new Member States or to some countries of 'Emerging Asia', the share of investment still appears to be rather low in most pre-accession countries.

Generally speaking, investments are an important driver of growth, whereas in countries with slow growth dynamics, consumption as a share of GDP appears to be rather high. Most pre-accession countries belong to this second group, which is characterised by fairly stable but moderate growth and quite a high share of consumption in GDP. However, this high share of consumption might also reflect relatively low levels of per-capita GDP, which impede the domestic accumulation of capital. In this type of situation, where capital markets are shallow, access to foreign capital is a crucial factor in enabling a country to achieve a rapid increase in its growth potential.

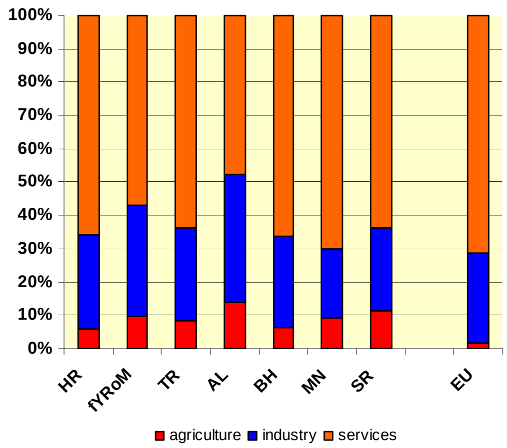
Table 1.2: **Private consumption (% of GDP)**

	2003	2004	2005	2006	2007	2008	Average
BG	71,3	70,8	70,7	72,8	72,2	71,4	71,5
CZ	53,7	52,9	51,0	50,2	49,7	50,2	51,3
EE	57,1	58,3	58,5	60,0	61,0	60,3	59,2
EL	72,0	71,3	72,9	73,4	72,6	72,8	72,5
LV	63,3	63,9	64,2	69,4	72,4	71,8	67,5
LT	62,7	65,3	68,0	69,7	71,1	71,7	68,1
RO	73,7	78,7	83,2	86,9	91,5	93,8	84,6
SI	56,7	55,8	54,8	53,3	53,3	52,5	54,4
SK	56,3	56,1	56,0	54,7	52,9	52,8	54,8
NMS	**63,0**	**63,7**	**64,4**	**65,6**	**66,3**	**66,4**	**64,9**
HR	64,6	64,5	64,5	63,2	63,6	62,7	63,9
fYRoM	73,7	76,4	77,6	79,1	82,0	83,5	78,7
TR	72,1	73,2	72,8	71,3	71,8	71,2	72,1
CC	**70,1**	**71,4**	**71,6**	**71,2**	**72,5**	**72,5**	**71,6**
AL	84,7	82,8	89,2	88,9	89,0	89,0	87,3
BH	90,0	90,0	90,9	84,6	80,7	80,1	86,1
MN	74,2	73,1	69,9	77,3	88,4	91,2	79,0
SR	73,8	79,3	79,0	77,9	80,9	82,6	78,9
Average PCC	**80,7**	**81,3**	**82,2**	**82,2**	**84,8**	**85,7**	**82,8**

Source: Thomson-Reuters, World Bank, National Statistical Offices

One of the main features on the supply side is the shift in value added from agriculture and industry towards services in most of the pre-accession countries. In tandem, resources were increasingly being allocated in non-tradable sectors such as construction, the domestic wholesale and retail trade, financial intermediation and real estate, primarily at the expense of manufacturing.

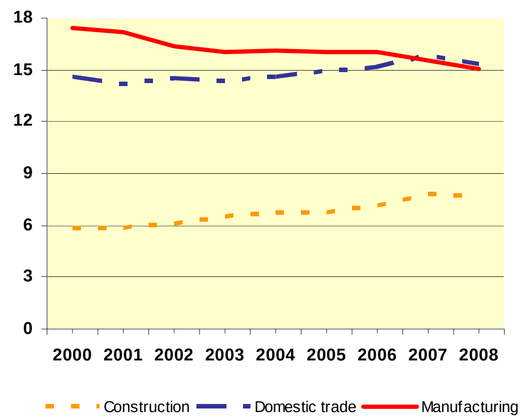
Graph 1.8: **Supply structure, % of 2007 Gross Value Added**



Source: Eurostat, National Statistical Offices

Following international trends, capital flows in search of higher investment yields were channelled through the financial system into the construction, real estate and retail trade sectors, fuelling soaring real estate prices and private consumption. In Albania, the construction sector almost doubled its share in national output from 8.6% of gross value added (GVA) in 2000 to 15.2% of GVA in 2007. In Croatia and Montenegro, a relative decline in manufacturing as a share of GVA was offset by the increased importance of the construction, financial intermediation and domestic trade sectors. In Serbia, the share of domestic trade increased from 6.6% of GVA in 2000 to 13.6% of GVA in 2008. Only Albania and the former Yugoslav Republic of Macedonia maintained the relative importance of the manufacturing sector in total output during 2000-2007. Moreover, in the latter case, the real estate sector expanded fairly robustly over the period, by some 30% – from 3¼% of GDP in the early 2000s, to 4½ of GDP in 2008.

Graph 1.9: **Economic activities as % of Gross Value Added**



Source: National sources

1.3. ECONOMIC DEVELOPMENTS IN THE CRISIS

The impact of the global financial crisis appears to have affected the pre-accession countries in a slightly different order and – more importantly – to a different degree.

The Turkish economy was hit the most rapidly and severely – the difference between peak and trough real GDP growth rates was more than 20 percentage points.([15]) The economies of Serbia

([15]) Growth deceleration is measured as the difference between the highest pre-crisis growth rate and the highest GDP contraction rate in the crisis.

and Croatia followed with growth decelerations of 12.9 and 11.0 percentage points. Kosovo and Albania remained relatively sheltered from the crisis, while the economies of the other pre-accession countries worsened more or less in step with the average of the EU economies.

Table 1.3: **GDP real growth, % y/y**

	Average 02-07	Q1'08	Q2'08	Q3'08	Q4'08	Q1'09	Q2'09	peak-trough difference
HR	**4,7**	4,3	3,4	1,6	0,2	-6,7	-6,3	**11,0**
fYRoM	**4,2**	5,6	6,7	5,8	2,0	-0,9	-1,4	**8,1**
TR	**6,9**	7,2	2,8	1,0	-6,5	-14,7	-7,9	**21,9**
AL	**5,8**	6,7	6,9	8,1	9,6	5,4	5,3	**4,3**
BH	**5,8**				5.5*		-3.0**	**8,5**
MN	**6,1**				7.5*		-2.0**	**9,5**
SR	**5,7**	8,8	6,4	4,6	3,0	-4,1	-4,0	**12,9**
KO	**3,6**				5.4*		4.1**	**1,3**
EU	**2,4**	1,9	2,0	1,0	-1,6	-5,2	-5,7	**8,6**

* Annual data
** Annual forecast

Source: National Statistical Offices, IMF, own calculations

The timing of the real economy's reaction to the crisis has also varied. While in Turkey and Croatia the first signs of the crisis became visible already in Q2 2008, in Albania they did not become visible until Q1 2009. Overall, the crisis was felt in most of the pre-accession economies with a lag of at least one quarter after the major EU economies.

The crisis impacted heavily on the more developed economies in the region (Turkey, Serbia and Croatia), which are better integrated in international production chains. The initial correction started not through the external trade channel but via domestic demand. Investment demand and household consumption decelerated rapidly in Croatia and Turkey by mid-2008, reflecting declining international capital inflows after the mid-2007 financial crisis. Industry and services mirrored these negative developments on the supply side. The economic downturn was intensified by a sudden and sharp contraction of external demand, starting in the fourth quarter of 2008. At that point, the crisis was being increasingly imported into the pre-accession economies through the trade channel. Montenegro, in view of its external accounts adjustment and the vulnerability of its small, non-diversified economy, was also severely hit by the crisis.

The crisis struck the pre-accession economies at a time when their GDP demand structure was clearly different from the EU average. In Turkey and Croatia, countries for which a detailed breakdown of demand is available, the first signs of correction in this growth pattern were already obvious in Q2 2008, when households reduced the pace of their consumption spending. In Turkey this was also accompanied by investment retrenchment, driven mostly by private sector construction. These developments show that by the time the crisis started in Croatia and Turkey, there had been an ongoing reduction in domestic demand because of a build-up of precautionary savings and a correction of excesses in some sectors.

By Q4 2008, quarterly growth rates (y/y) had turned negative in Turkey and remained close to zero in Croatia, while the other pre-accession countries continued to show positive growth. The situation changed in the first half of 2009 when in all of these countries, with the exception of Albania, economic growth moved into negative territory.

In the midst of the crisis, investment growth in Croatia and Turkey decelerated at double-digit rates, close to the EU average. At its worst, household consumption fell by approximately 10% but its deceleration has been much more pronounced than in the EU – 16 percentage points compared with only 4 percentage points in the EU. As a result, reductions in imports were much more pronounced in these two countries, while exports decelerated more or less at the EU's pace. Government consumption continued to grow, albeit at lower rates, and clearly not exhibiting an upturn as in the EU. Due to a lack of quarterly data, demand developments cannot be analysed in all countries.

Supply reaction

On the eve of the crisis the pre-accession economies had more or less similar supply structures. In general, their agriculture sectors had a higher share in the gross value added compared to the EU and services were still underdeveloped. In some countries the share of services in GVA was below 60% (former Yugoslav Republic of Macedonia) and in Albania it was even below 50% of GVA. The contribution of industry and construction to GVA ranged from close to 40% in Albania to about 20% in Montenegro but on average were close to the EU average.

The agricultural sector served as a stabilising factor. It remained almost unaffected by the developments of the crisis and made a positive contribution to growth in all pre-accession countries.

The brunt of the adjustment was taken by the industry and construction sectors. Growth decelerations in this sector reached more than 20 percentage points in Turkey and Serbia, and double digits in Croatia and the former Yugoslav Republic of Macedonia. The average adjustment in the EU was about 20 percentage points.

In the three most advanced economies of the pre-accession countries (Serbia, Croatia and Turkey) the crisis impacted particularly heavily on the services sector. While average growth deceleration in the EU was about 6 percentage points, it reached 15 percentage points in Turkey and was close to 10 percentage points in Serbia and Croatia. Nevertheless, thanks to a still positive growth differential between services and the overall GDP growth, economic structures continued to shift towards a higher share of services in the GVA.

2. GROWTH VULNERABILITIES AND POLICY REACTIONS

2.1. EXTERNAL IMBALANCES

The emergence of external imbalances in the form of large current account deficits and increasing external debt levels has often been identified as one of the key pre-crisis vulnerabilities of candidate and potential candidate countries. This vulnerability was expected to lead to huge adjustment shocks and an exacerbation of the impact of the crisis. At the same time, differences across the region were acknowledged. This section provides stylised facts about current account developments prior to the outbreak of the crisis and takes a look at the main external adjustments during the crisis.

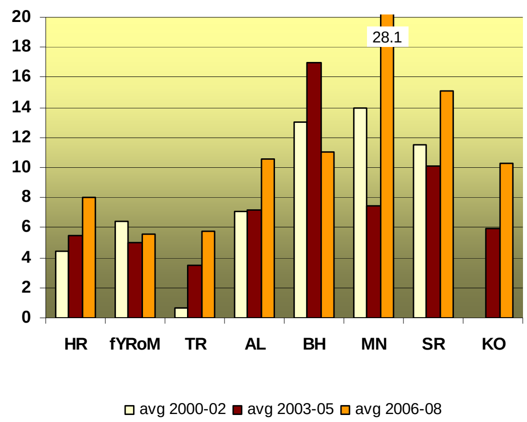
2.1.1. Pre-crisis current account developments

The favourable international environment with ample liquidity and relatively easy access to international financing drove the current account balances of pre-accession countries to gradually widening deficit positions during this decade, although at a different pace across the region. This is a priori not surprising, as transition and emerging markets can benefit from foreign savings in order to promote development and growth. It can be a rational strategy to finance externally domestic investments, when domestic savings are scarce and a proper business environment is in place. However, this strategy is not always risk-free, as demonstrated by past episodes of debt crisis in several emerging countries.

Over the period 2003-2008, current account deficits in the candidate and potential candidate countries almost doubled on average as a share of GDP, from 8% to 15.6%. The average figures mask, of course, significant differences across the countries. Croatia's and Turkey's current account deficits widened by around 3 percentage points of GDP over the period 2003-2008 to 9.4% of GDP and below 6% of GDP, respectively. Current account developments in the former Yugoslav Republic of Macedonia have been more uneven and volatile. Years of sizeable deficits have alternated with relatively moderate deficit positions or roughly balanced current accounts.

In the potential candidate countries, current account deficits have been considerably higher than in the candidate countries. In fact, in Bosnia and Herzegovina, Montenegro and Serbia, external deficits have almost persistently been in double-digit territory, with Montenegro being a particular outlier. Albania exhibited relatively moderate single-digit deficits until 2005, but they increased significantly thereafter. The deficit increase over the period 2003-2008 was particularly pronounced in Montenegro (by more than 23 percentage points of GDP), whereas Albania, Kosovo and Serbia recorded increases of around 8 percentage points.

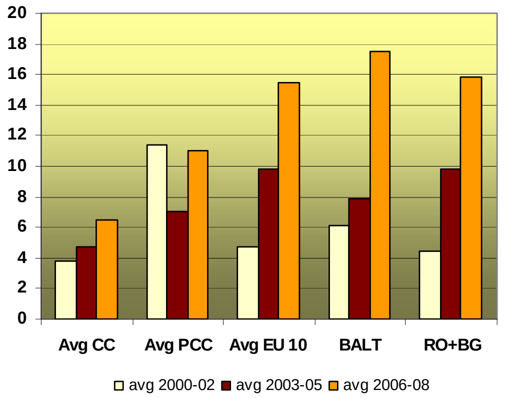
Graph 2.1: **Current account developments in candidate and potential candidate countries, deficits % GDP**



Source: ECOWIN, own calculations

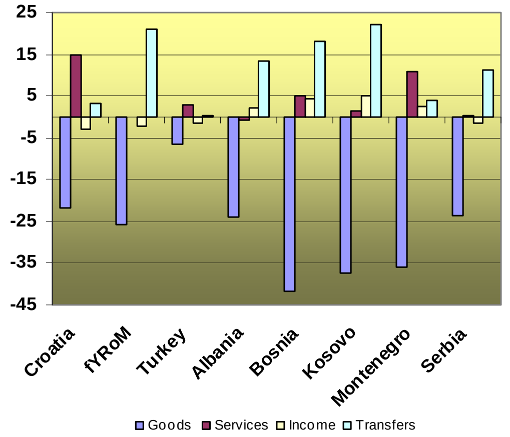
Cross-country comparisons reveal that current account developments in the three candidate countries have on average been more moderate than in the group of 10 new Member States. However, compared to the Czech Republic and Slovakia, external imbalances appear relatively high. Developments in the potential candidate countries seem to be similar to the Baltic countries as well as Bulgaria, and, to a lesser extent, Romania. The chart shows a positive correlation between higher growth rates and external imbalances. In the group, the potential candidate countries exhibit relatively high current account deficits compared to their average growth performance.

Graph 2.2: **Current account developments in comparison, deficits % of GDP**



Source: ECOWIN, own calculations

Graph 2.3: **Structure of current accounts, % GDP in 2003-2008**



Source: ECOWIN, own calculation

Taking a look at the structure of the current account balances reveals differences across the region. First, all candidate and potential candidate countries, with the exception of Turkey, have huge merchandise trade deficits. They account for around 20-25% of GDP on average in 2003-2008 in the case of Croatia, the former Yugoslav Republic of Macedonia, Albania and Serbia, and exceed 35% of GDP in Bosnia and Herzegovina, Kosovo and Montenegro. The persistence of large trade deficits raises issues of underlying structural problems in the catching-up process, such as a weak industrial base, limited technological progress, and slow progress in enterprise restructuring in general. In Croatia, and to a lesser extent in Montenegro, large trade deficits have traditionally been "financed" by surpluses on the services account, stemming mainly from the tourism sector. Therefore, arguably a comparatively higher trade deficit can be afforded in such cases. Another striking feature is that the former Yugoslav Republic of Macedonia as well as most potential candidate countries have relied heavily on foreign transfers, in the form of remittances, to "finance" a considerable share of their trade gaps.

From a pure accounting perspective, the widening or narrowing of the external balance may result from changes in savings or investment behaviour, or a combination of both. Moreover, savings-investment balances can be further broken down into a private sector and public sector component to allow an analysis of the relevance of the economy's sectors for the evolution of external imbalances in the past. Some main findings, covering the period 2005-2008, can be summarised as follows.([16])

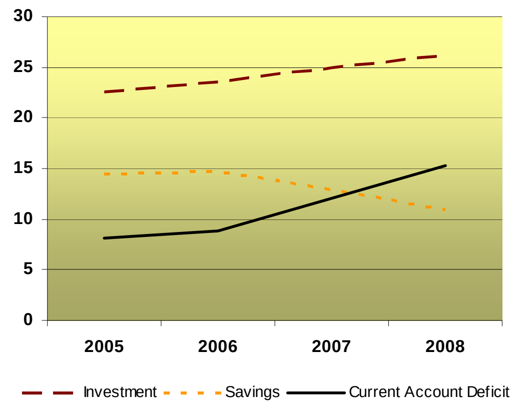
First, as Graph 2.3 depicts, the widening of the current account deficit for the region resulted from both a steady increase in investments and a decline in the savings ratio. In some potential candidate countries such as Serbia, Albania and Montenegro the decline in savings was much stronger than that observed in the candidate countries. In fact, in Montenegro the savings rate even became negative. On average, the savings ratio in the pre-accession countries declined to slightly above 10% of GDP in 2008, compared to a savings rate of

([16]) These findings have to be taken with a great deal of caution, due to national accounts data limitations and methodological problems, eg private sector balances are calculated as a residual and it is assumed that the public sector is equivalent to the general government balance. However, the analysis could nonetheless provide some broad indications as to the domestic "origin" of external balances.

close to 20% in the new EU Member States in central and eastern Europe.

Second, the theory of "twin deficits" according to which widening external deficits are primarily driven by larger fiscal deficits apparently does not apply for all countries of the region (see Annex 1). On the contrary, in Croatia, the former Yugoslav Republic of Macedonia and Montenegro, the widening of the current account deficit took place during considerable fiscal consolidation. Thus, a major savings-investment gap developed in the private sector, resulting from a decline in private savings and strong investment activity. Even in countries which increased their fiscal deficits (Albania and Serbia), the private sector seemed to have been the main driver of widening external deficits. Bosnia and Herzegovina appears to be a somewhat different case. The country actually narrowed its external deficit despite a considerable weakening of its fiscal balance. In summary, a strong rise in investments, in particular of the private sector, seem to have played a significant role in the widening of savings-investment gaps. The relatively low capital endowment of the country, gradual improvements in the business environment, strong FDI inflows as well as infrastructure reforms may partly explain the buoyant investment growth over recent years. At the same time, it is evident that countries such as Montenegro, Serbia, and to a somewhat lesser extent also Albania, are good examples of countries which used external financial resources primarily to finance a domestic private consumption boom. Fiscal policy does not appear to have been the main "driving force" behind the widening of external deficits in the region (see also below section 2.3.2 on fiscal developments).

Graph 2.4: **Savings and investment in candidate and potential candidate countries, % GDP**

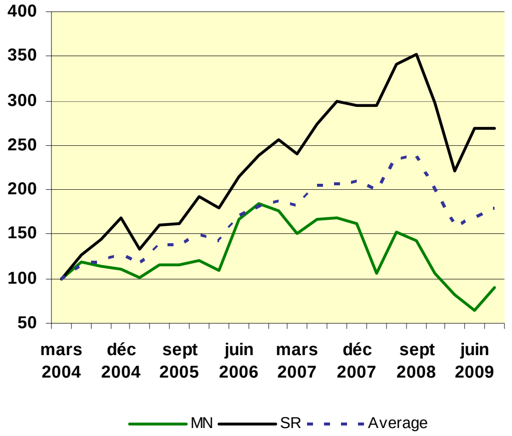


Source: National sources, own calculations

2.1.2. Current account developments during the crisis

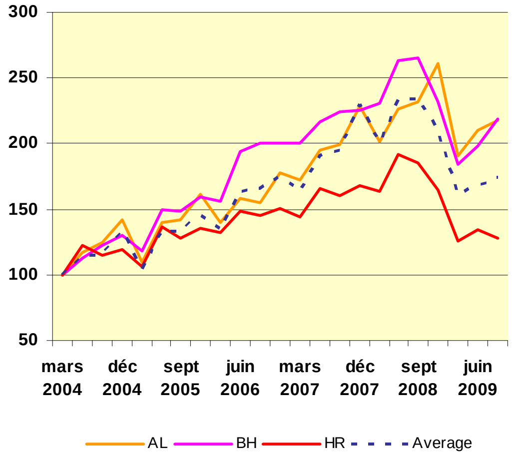
In times of global shocks, such as the recent financial crisis, the adjustment of high current account deficits becomes inevitable. In the case of the pre-accession countries, this adjustment already started in 2009. Interestingly enough, the impact of the global financial crisis on trade flows appears to have been more pronounced in countries with a lower trade orientation (e.g. Serbia, Bosnia and Herzegovina, Montenegro) than in countries with a relatively large and more diversified trade sector. The most noteworthy drop in exports appears to have taken place in Serbia (in large part due to the steel sector), in Bosnia and Herzegovina, where export growth was very strong during the years of high growth, and in Montenegro, where export growth had been relatively low, when compared to the other countries in the group. In the latter, exports appear to have dropped below levels reached in 2004.

Graph 2.5: **Commodity exports of potential candidate countries**



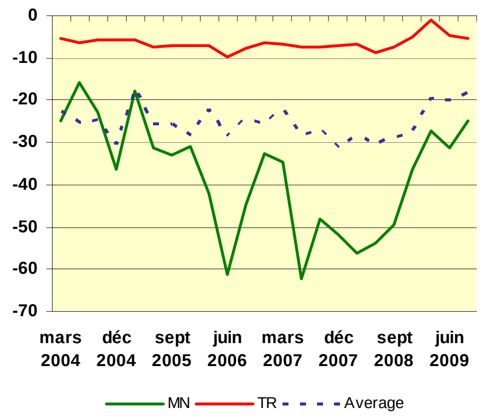
Source: Thomson-Reuters, own calculations

Graph 2.6: **Commodity imports of potential candidate countries**



Source: National sources

Graph 2.7: **Development of trade balances, % GDP**



Source: Thomson-Reuters, own calculations

In terms of timing, the crisis appears to have hit the economies, mainly in the fourth quarter of 2008 and the first quarter of 2009, when exports fell back sharply to levels registered in 2006. However, in the second and third quarter of 2009, exports appear to have recovered (on a quarter-to-quarter base) in most countries of the region, most likely reflecting a recovery of external demand.

The performance of imports was very similar to that of exports. In most countries imports rose markedly during the years of strong growth, reaching a peak in the second and third quarters of 2008, and dropping quickly as a result of declining demand within two quarters back to levels registered in late 2005 and early 2006, also in Croatia where the rise in imports had been less pronounced. The steep drop in imports was also due to the high import component of exports in the region.

As a result, trade balances improved in all countries of the region. The trade deficit, dropped from around 30% of GDP on average at the end of 2008 to some 20% in the first quarter of 2009.

Revenues from the export of services (mainly tourism and the provision of construction abroad) are an important source of income for Croatia, Turkey and Montenegro. At the outbreak of the financial crisis, the stability of those revenues appeared to be at risk. However, so far, the inflow of foreign exchange through this channel seems to have remained relatively stable.

Table 2.1: **Service account, % of GDP**

	2007	Average 2002-2007	2008	2009Q1-3
Albania	0,2	-0,8	0,8	0,7
Bosnia and Herzegovina	5,6	4,6	5,4	4,0
Croatia	14,6	14,5	14,7	14,6
Kosovo	1,0	1,7	2,1	N.A.
Montenegro	16,4	10,5	13,1	12,3
fYRoM	0,4	-0,2	0,1	0,4
Serbia	-0,9	0,6	-0,6	-0,1
Turkey	2,0	3,0	2,3	2,7

Source: Eurostat, Thomson-Reuters

For some of the (potential) candidate countries, current transfers, in particular in the form of workers' remittances, represent a fairly important source of capital inflows. With the exception of Turkey, Croatia and Montenegro, net-inflows of current transfers as a share of GDP were in the double-digit range on average during 2002-2007. For example, in Bosnia and Herzegovina and Kosovo, they reached some 20% of GDP, which was almost half of the countries' trade deficit. Data for the first three quarters of 2009 point only to a marginal decline in this category in some countries, while in others, such as Serbia and the former Yugoslav Republic of Macedonia it even increased.

Table 2.2: **Current transfers, % of GDP**

	2007	Average 2002-2007	2008	2009Q1-3
Albania	13,1	13,7	11,2	10,0
Bosnia and Herzegovina	17,7	19,3	14,6	11,4
Croatia	2,4	3,4	2,2	2,2
Kosovo	23,4	22,0	21,6	N.A.
fYRoM	16,5	15,3	14,4	15,9
Montenegro	2,2	4,4	2,4	2,3
Serbia	9,7	11,5	9,7	11,2
Turkey	0,3	0,4	0,3	0,3

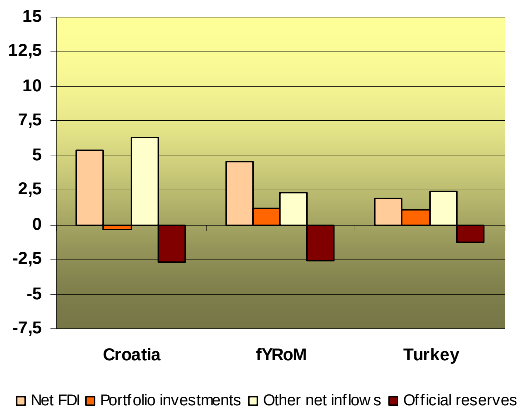
Source: National sources

In conclusion, when looking at the main current account components, available data points to a significant correction in trade deficits, mainly due to a rather swift response of imports to declining domestic and external demand. Nevertheless, trade deficits still remain relatively large. The service balance is of relevance in Croatia, Montenegro and Turkey, mainly due to sizeable tourism revenues of those countries. So far, income from tourism appears to have remained quite resilient to the crisis. Current transfers are important for most other (potential) candidate countries, in particular in the form of workers remittances. But there too, transfers seem to have remained relatively stable in most countries. The most noteworthy exception is Bosnia and Herzegovina, where the inflow of current transfers appears to have been declining for a couple of years already.

2.1.3. External financing

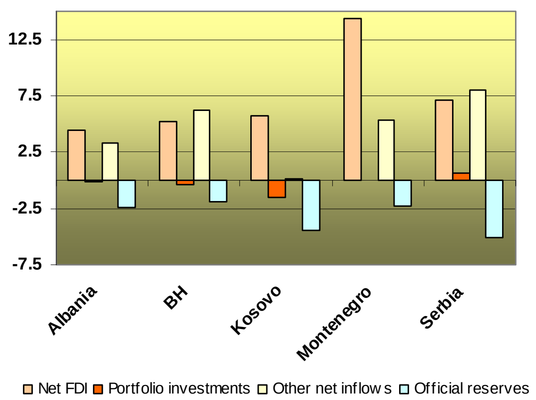
Over recent years current account deficits in candidate and potential candidate countries have actually been over-financed by net capital inflows. All countries have managed to accumulate – in some cases sizeable – official reserves. Moreover, net inflows of FDI have "financed" a considerable part of the current account deficits. In the case of Croatia, net FDI inflows have on average matched three quarters of the size of current account deficits over the period 2003-2008. Large FDI transactions can actually even surpass the size of the current account deficit in a single year, as was seen in the former Yugoslav Republic of Macedonia in 2006 and 2007. Another interesting feature is that "other net inflows" provided the bulk of external financing, in terms of GDP, in a number of countries, such as Croatia, Turkey, Bosnia and Herzegovina and Serbia. This reflects a process of deeper financial integration with the EU, as it comprises primarily cross-border financing provided by foreign parent banks in the EU. This process played a less prominent role in the former Yugoslav Republic of Macedonia and Albania, possibly reflecting a lower state of development of the financial sector and an earlier stage of integration with EU financial markets. Finally, portfolio investments have played a minor role, if any, in most of the countries of the region, with the possible exception of Croatia. The low share of portfolio investments in total external financing is a reflection of the still infant state of capital markets development.

Graph 2.8: **External financing 2003-2008, % GDP**



Source: ECOWIN, own calculations

Graph 2.9: **External financing 2003-2008, % GDP**



Source: ECOWIN, own calculations

The candidate and potential candidate countries had differed in their ability to attract foreign financing and, therefore, they had different starting points prior to the crisis. Accumulated financial account surpluses over 2002-2007 represented only about 20% of GDP in Kosovo and Turkey and reached close to 80% of GDP in Serbia. Turkey stood out as the only country in which financial account surpluses did not reach double-digit levels in 2008, while in 2009 only Serbia and Albania are expected to have surpluses of above 10% of GDP.

The financial and economic crisis did not lead to a sudden stop and external financing continued to flow to the region, albeit at significantly lower levels. Financial accounts remained positive in 2008 in all countries, without noticeable divergence from previous patterns. In Albania the financial account surplus even almost doubled that of the previous year. Nevertheless, preliminary data for 2009 show that financial inflows have started to decelerate. And in most of the countries, with the exception of Serbia, the deceleration was rapid. Despite these developments, reserve assets stabilised in 2009 and even increased significantly in some countries. Foreign parent banks have not reduced their exposure to the region significantly, regardless of whether or not the country was part of the "European Bank Coordination Initiative" (Bosnia and Herzegovina and Serbia in the context of their IMF programmes).

Table 2.3: **Financial account flows, % of GDP**

	2007	average 2002-2007	cumulative 2002-2007	2008 total	Sep 2009*
HR	11,3	10,9	53,7	11,8	5,6
fYRoM	9,9	7,8	34,6	12,5	5,0
TR	6,8	5,2	22,7	5,1	0,3
AL	9,6	5,7	28,3	16,8	9,4
BH	13,2	12,7	59,5	12,7	1,1
MN	26,9	8,7	46,5	33,9	0,4
SR	18,6	17,7	78,4	12,3	8,5
KO	11,1	3,1	17,9	10,1	n.a

* Data as of end of September as a ratio to the annual GDP forecast.

Source: National Central Banks and the IMF

Along with the slowdown of external financing, there is also an ongoing change in its structure ([17]). In 2009, net FDI and loans were falling as a ratio to the expected GDP in comparison with previous years. ([18]) As a consequence, the share of net FDI is expected to have been lower in Croatia and the former Yugoslav Republic of Macedonia but to have remained relatively stable or even to have increased in the other countries due to a faster reduction in the overall financial account surplus. While in 2008 net FDI represented 40-60% of all

([17]) As the most recent balance of payment data is prone to revisions, which could be substantial in some cases, the following observations are only preliminary and should be taken as a first glance at the changing external financing patterns.

([18]) Cumulative net portfolio investment (2002-2007) reached 6.4% of GDP in the former Yugoslav Republic of Macedonia and 4.8% of GDP in Turkey. Cumulative trade credits and other investments (2002-2007) were especially important in Montenegro where they reached 24% of GDP. Cumulative credits and deposits (2002-2007) reached -15.9% of GDP in Montenegro and -10.1% of GDP in Bosnia and Herzegovina.

financial inflows in most countries, its size in 2009 differs widely across the pre-accession countries, with Montenegro's and Albania's FDI attractiveness seemingly unaffected by the crisis. Still, it is noticeable that all economies have been able to continue to attract direct investments from abroad while net loans turned negative or close to zero.

Table 2.4: **Net Foreign Direct Investment, % of GDP**

	2007	average 2002-2007	cumulative 2002-2007	2008 total	Sep 2009*
HR	8,1	4,6	23,8	6,8	1,9
fYRoM	8,8	4,7	22,3	6,3	1,4
TR	3,0	1,6	8,0	2,3	0,9
AL	6,0	3,9	19,0	6,8	6,2
BH	13,7	6,8	33,9	5,7	1,4
MN	18,7	6,7	35,3	18,4	23,6
SR	6,2	6,7	30,0	5,3	3,3
KO	12,0	3,8	22,0	9,0	n.a

* Data as of end of September as a ratio to the annual GDP forecast.

Source: National Central Banks and the IMF

Table 2.5: **Net loans, % of GDP**

	2007	average 2002-2007	cumulative 2002-2007	2008 total	Sep 2009*
HR	6,7	6,2	30,8	7,6	2,1
fYRoM	-2,1	0,2	0,0	3,3	-0,1
TR	4,2	2,4	10,7	4,3	-2,2
AL	1,2	1,9	8,6	4,6	0,0
BH	3,2	2,5	11,7	3,6	0,6
MN	26,4	6,9	37,8	19,9	2,4
SR	11,5	7,7	35,1	9,1	1,9
KO	0,3	0,2	1,3	1,4	n.a

* Data as of end of September as a ratio to the annual GDP forecast.

Source: National Central Banks and the IMF

The crisis has also changed the pattern of increasing official reserves. In 2008 all pre-accession economies, with the exception of Albania, lost some of their reserves. The loss was higher in Serbia and Montenegro where there was a substantial deposit withdrawal from commercial banks driven by a short-lived banking panic. In 2009 reserve assets stabilised in all pre-accession countries and were not very much different from their pre-crisis levels. The reallocation of Special Drawing Rights in summer 2009 contributed to this development, as well as the disbursements under the IMF Standby Arrangements in the cases of Bosnia and Herzegovina and Serbia.

Table 2.6: **Change in reserves assets, % of GDP**

	2007	average 2002-2007	cumulative 2002-2007	2008 total	Sep 2009*
HR	-1,7	-2,4	-11,6	0,7	0,2
fYRoM	-1,8	-2,1	-10,9	0,5	-0,7
TR	-1,2	-1,8	-6,6	0,2	0,0
AL	-1,9	-2,2	-10,6	-2,2	-0,6
BH	-5,7	-3,6	-18,3	1,6	2,5
MN	-5,4	-2,0	-10,3	5,0	-3,2
SR	-2,5	-6,9	-29,8	5,0	-4,4
KO	-8,5	-1,0	-6,5	0,1	

* Data as of end of September as a ratio to the annual GDP forecast.

Source: National Central Banks and the IMF

2.1.4. External debt developments

The relation between external debt and the current account is not as straightforward as often assumed. First of all, foreign debt is usually denominated in foreign currency (mostly euro for the countries of interest) whereas GDP is in national currency, so that a real appreciation (e.g. a constant nominal exchange rate with higher domestic inflation than abroad) leads to a lower debt-to-GDP ratio. This was a factor which contributed to moderating external indebtedness in pre-accession countries before the crisis. External debt relative to GDP has also been fairly constant between 2003 and 2007, with the notable exceptions of Croatia, where the ratio changed rather quickly ([19]). By comparison, in the 10 new EU Member States, this ratio went up faster and reached a level above 90% of GDP in 2009 (up to 130% in some cases), substantially higher than the 50% level recorded in the pre-accession economies.

Fundamentally, however, a distinction has to be made between public and private foreign debt. In most countries under observation, the bulk of foreign debt is now private.

([19]) In the case of the former Yugoslav Republic of Macedonia the sharp rise in the debt ratio between 2004 and 2007 is probably largely due to a change in methodology.

Table 2.7: **External debt, % of GDP**

	2003	2007	2008	2009 (i)
Croatia	66,3	77,6	82,4	86,5
fYRoM	39,7	52,5	49,1	51,6
Turkey	47,6	38,2	37,9	39,8
Albania	21,9	18,0	20,4	21,4
BH	53,5	48,5	42,5	44,6
Montenegro	49,5	54,8	46,2	48,5
Serbia	68,8	60,2	63,6	76,0
EU-10 (ii)	56,5	88,1	86,6	90,7
Latvia	84,0	135,4	124,0	133,9

(i) Commission Services forecast
(ii) excluding the Czech Republic
Source: National sources

The fact that foreign debt is mostly private has one important implication: the private sector has to service the debt ultimately with exports (of goods and services). Hence, the foreign debt-to-exports ratio is to some extent more relevant for private debt than the standard debt-to-GDP ratio, which is more relevant for public debt since the tax base for public debt is GDP. The table below shows the external debt-to-exports ratio. It rose very significantly albeit gradually in Croatia. The other countries' ratios were mainly affected by the dramatic fall in exports in 2009, as a result of the sizable trade contraction which occurred in the crisis. Overall, it appears that the foreign debt stock may be more sensitive to trade developments in Turkey and Serbia than in the other countries under observation.

Table 2.8: **External debt, % of exports**

	2003	2007	2008	2009 (i)
Croatia	151,3	181,2	197,4	256,6
fYRoM	105,6	105,4	102,4	136,2
Turkey	204,9	171,6	157,8	205,1
Albania	107,4	64,5	67,8	74,6
BH	183,0	69,6	61,2	70,4
Montenegro	88,6	100,9	122,6	147,1
Serbia	311,5	220,1	204,9	250,0
EU-10 (ii)	116,7	159,0	155,3	199,7
Latvia	201,0	326,5	296,7	430,2

(i) Commission Services forecast
(ii) excluding the Czech Republic
Source: National sources

The stock-flow adjustment may also play an important role. Turkey trades mainly in euro and has a still significant dollar share in foreign debt. Therefore, it may be sensitive to euro/dollar rate volatility. This effect may be to some extent important for Turkey, but much less important for the other pre-accession countries which do not have large stocks of foreign assets.

Overall, the risks to sustainability of foreign debts and thus to the current account depend on the level of, and potential changes in the growth rate of exports (mainly relevant for private debt), tax collection, the interest rate, and the currency risk due to the structure and the denomination of external debt and trade flows. Using the available data over the previous years it could be argued that sustainability has not really been a problem. However, risks have risen in the crisis context and appear somewhat higher in Croatia, and to a lesser extent in Turkey and Serbia, mainly because of weaker export capacity. In the other candidate and potential candidate countries risks appear much lower than in most of the new Member States, as the latter were able to draw earlier and more heavily on external capital flows.

2.2. FINANCIAL SECTOR

The financial sector in candidate and potential candidate countries is largely dominated by banks, which are mostly privatised and in foreign, mainly European, ownership. The state of development of the financial sector before the crisis differed widely across the region. The development was nevertheless characterised by some common trends, including financial deepening, continuing consolidation in the banking sector, a continued shift towards privately-owned banking systems, a move towards core banking activities (i.e. lending to the private sector rather than to governments) and closer integration into international financial markets through increased foreign bank ownership. This process of financial deepening reflected a catching-up process, but also the surge in international capital flows. It also shows the increasing role of the financial sector as a source of funding, even though the largest source of funding for investment in the corporate sector remained the firms' own resources, as Handjiski (2008) points out.

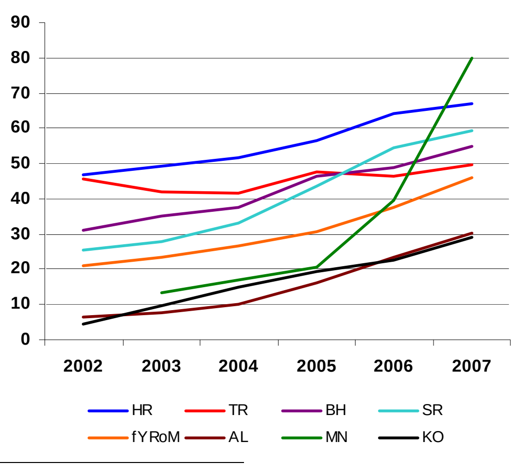
Table 2.9: **Developments in the banking sector 2008**

	HR	fYRoM	TR	AL	BH	MN	SR	KO
Number of banks	33	18	49	16	20	11	34	8
Foreign ownership	90.8%	84%	15%	91.9%*	94%	85%	75%	90%
State ownership	4.4%	5.4%	22%	1.1%	1.3%	0%	16%	0%
Capital Adequacy Ratio	14,5	16,2	18,1	17,2	16,3	15,0	21,9	16,49
Return on Asset	1,6	1,4	1,9	0,9	0,4	-0,6	2,1	2,2
Return on Equity	14,0	12,5	16,5	11,4	5,2	-6,9	9,3	20,2
Proportion FX liabilities	53,7%	49,0%	24,2%	48,5%	65,0%	5,4%	55,0%	0%
Proportion FX assets	61,3%	52,3%	34,0%	48,9%	13,5%	5,1%	21,5%	3,6%

Source: National sources

The period 2002-2007 saw a constant expansion of domestic credit in all pre-accession economies, though in most countries from a very low level, as financial intermediation was quite underdeveloped in the region at the beginning of the decade. In 2007, the highest levels of domestic credit as a share of GDP and the largest increases over this period were recorded in Montenegro. Increases in the other countries hovered around 20-35 percent of GDP.

Graph 2.10: **Domestic credit to GDP, %**



Source: National sources

During the boom phase, the countries of the region took a number of policy measures to rein in overheating pressures. Some countries, in particular those with a more flexible monetary policy setting, such as Turkey, Albania and Serbia sought to reduce credit growth primarily through adjustments in policy rates and reserve requirements. In countries where the monetary regime is characterised by a closer peg to the euro (e.g. Bosnia and Herzegovina, Croatia) or where the euro is the official tender (Montenegro, Kosovo), the scope for monetary policy was inevitably more limited. The authorities in those countries nonetheless tried to manage credit growth and demand by increasingly deploying adjustments of reserve requirements and other "administrative" measures.

Overall, policy responses were only partly successful. Limits on domestic credit growth were to some extent circumvented as domestic banks increasingly reverted their (corporate) customers to their parent banks abroad. In Serbia, Montenegro and Croatia net foreign loans were on average above 6% of GDP in the period 2002-2007 and cumulatively above 30% of GDP – a result hardly conducive to stemming strong domestic demand and high current account deficits.

Table 2.10: **Foreign loans, * % of GDP**

	2002	2003	2004	2005	2006	2007	average 2002-2007	cumulative 2002-2007
HR	2,0	9,3	5,3	6,4	7,4	6,7	6,2	30,8
fYRoM	-0,2	1,3	0,2	2,1	-0,3	-2,1	0,2	0,0
TR	2,4	0,1	1,7	2,4	3,5	4,2	2,4	10,7
AL	2,5	2,1	2,5	1,7	1,4	1,2	1,9	8,6
BH	3,6	3,2	-0,2	3,7	1,6	3,2	2,5	11,7
MN	0,9	2,2	3,3	3,1	14,9	26,4	8,5	50,8
SR	4,5	5,1	6,6	8,8	9,9	11,5	7,7	35,1
KO	0,0	0,0	0,1	0,8	0,2	0,3	0,2	1,3

* Balance of payments data.

Source: National Central Banks

In the boom years before 2008 total commercial banks' net foreign assets (NFA) declined as the domestic banking sector increasingly based their credit growth on foreign savings. Taking into account developments of central banks' NFA, financial systems' NFA remained positive across all pre-accession countries. Despite domestic credit expansion in this period, commercial banks' NFA worsened most notably in Serbia and Montenegro by 12% and 16% of GDP, respectively. Serbia also stood out among the other countries because nearly half of the domestic credit growth between 2002 and 2007 represented a rise in claims on the National Bank of Serbia and did not represent an extension of credit to the real sector of the economy. This development was mainly a result of the measures undertaken by the central bank to curb the rise in credit.

Box 2.1: Measures to stem excessive credit growth in Croatia and Montenegro

Croatia introduced in 2004 reserve requirements on domestic banks' foreign borrowing, a quasi-tax on capital inflows. The marginal rate was subsequently increased from initially 24% to eventually 55% in December 2006. Further, Croatia introduced special reserve requirements on domestic banks' bond issues. Croatia also introduced ceilings on domestic credit growth in 2007, as had been previously done in 2003. Banks whose credit growth exceeded the specified threshold were obliged to purchase low-yielding central bank bills for 50% of the excess credit growth. The measures were modified and effectively tightened subsequently in 2008, also with a view to closing existing loopholes, and were eventually quite effective in curbing domestic credit growth to households and the corporate sector.

In Montenegro, a first attempt by the Central Bank, requesting lenders to keep extra reserves as from October 2007, in order to curb the very fast credit growth came belatedly and proved insufficient. A second set of more restrictive measures, including credit growth ceilings, entered into force at the beginning of 2008. In addition, commercial banks gained access to the Central Bank's credit registry, improving the lender's risk management by checking the indebtedness of their clients. With the advent of the international financial crisis all restrictions on lending expansion were abolished in January 2009.

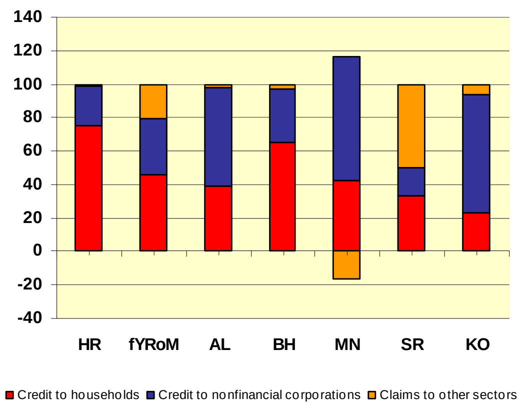
Table 2.11: **Net foreign assets, % of GDP**

	2002	2003	2004	2005	2006	2007
HR	-4,3	-6,4	-7,2	-11,9	-12,7	-6,0
fYRoM	8,9	9,3	9,9	8,1	7,3	4,1
TR	1,4	0,0	0,2	-2,3	-1,2	-1,1
AL	10,8	8,9	9,3	8,8	8,1	6,3
BH	-2,4	-6,0	-4,7	-9,0	-8,9	-7,4
MN	5,0	0,9	-1,1	2,3	-1,4	-16,3
SR	3,8	3,2	-1,3	-7,4	-12,7	-8,0
KO	10,5	8,1	10,1	9,8	10,5	9,3

Source: National Central Banks

In most countries, credit to households increased at a faster pace than credit to non-financial corporations, both starting from a very low base. Only in Albania, Montenegro and Kosovo did enterprises receive the bulk of the credit growth. Throughout this period, deposit bases kept up with the rapid expansion of domestic credit and loans-to-deposit ratios stayed below 1 in all pre-accession countries. The financial systems in these countries have had high levels of euroisation both on the assets and the liabilities side. Kosovo and Montenegro have been using the euro as their official tender. By end-2007, about half of all deposits and two-thirds of the loans to the private sector in the region were foreign currency denominated or foreign currency indexed.

Graph 2.11: **Shares in domestic credit growth, 2002-2007, %**



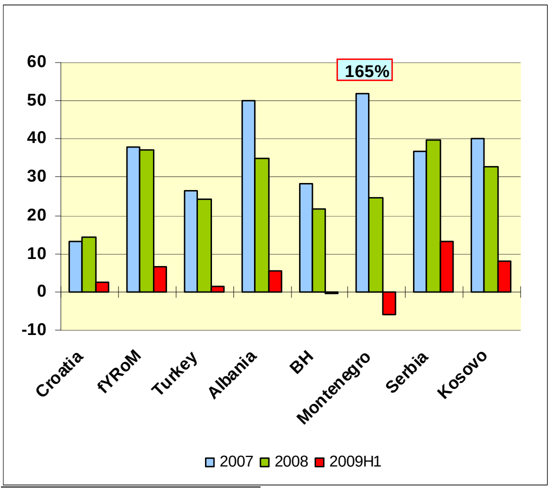
Source: National Central Banks

The role of the financial channel in the candidate and potential candidate countries as a transmission mechanism of the crisis appears so far to have been mostly limited to the dwindling of foreign capital inflows channelled through the banking sector. The comparatively low global financial integration of most countries and their very marginal exposure to financial assets at the core of the turmoil partly explain this outcome. Capital inflows continued an upward trend between mid-2007, at the onset of the global financial crisis, and mid-2008 in many countries. However, the situation changed following the intensification of the crisis in autumn 2008. The economies faced serious limitations in accessing international financial markets and the banking sector, became more risk-averse and tightened lending conditions. The liquidity situation of the banking system came under stress and "mini bank-runs" were observed in Bosnia and Herzegovina, Montenegro and Serbia in the month of October 2008. A sudden spike in global risk aversion and mounting liquidity constraints triggered a strong retrenchment of private capital inflows, in particular in terms of portfolio investment (inflows turned negative in most countries) and foreign direct investment.

Tighter external financing constraints had an impact on domestic liquidity and interest rates in most of the countries of the region. Both money market and interest rates on long-term loans have gone up in Western Balkan countries, increasing financing costs for private households and the corporate sector, slowing domestic consumption and investment. Deteriorating domestic liquidity conditions also led to higher money market interest rates between October 2008 and May 2009 before the trend reversed without having returned to pre-crisis levels yet. As regards lending, interest rates remained at elevated levels.

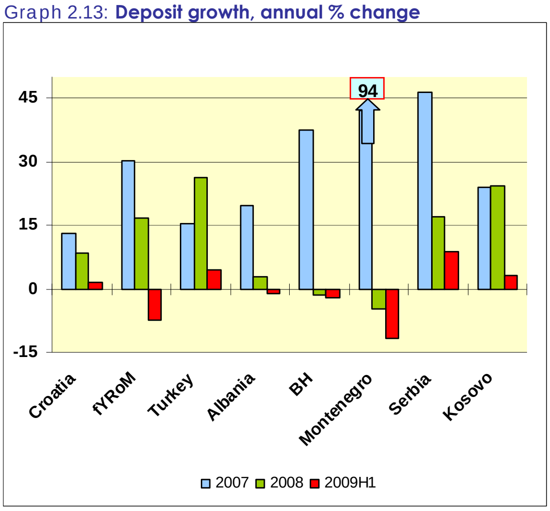
Credit growth decelerated significantly starting in the last quarter of 2008, except for Serbia, which still recorded double-digit growth. In Bosnia and Herzegovina and Montenegro credit growth turned negative in the first half of 2009, where a liquidity shortage triggered by the withdrawal of deposits particularly constrained the lending capacity of the banking sector. Thereafter, like in most other countries of the region, the deceleration became more subdued. Restrictions came from both the demand and the supply side. The increase in government borrowing could not make up for the loss in private sector demand but it changed the structure of outstanding credit. On the supply side, banks requested higher risk premiums and applied stricter lending policies, partly as a reaction to rising ratios of non-performing loans, increased uncertainties regarding real sector activity, higher costs for attracting new deposits and slowing or even falling deposit growth which eroded their liquidity situation. The mini-bank runs recorded in the last quarter of 2008 increased also the demand for foreign currency as deposits were shifted into foreign currency. This put pressure on exchange rates which was reflected in decreasing official foreign exchange reserves in countries with fixed currency regimes and, though to different degrees, in a depreciation of the local currency in those with flexible regimes.

Graph 2.12: **Credit growth, annual % change**



Source: National Central Banks

Graph 2.13: **Deposit growth, annual % change**



Source: National Central Banks

The financial sector in the region was overall sound and relatively stable, after it had overcome the effects of several banking crises in the region in the 1990s and early 2000s. It benefited from the increasing pace of prudential and banking sector reforms, partly also driven by the EU accession process. This can be illustrated by the EBRD

Box 2.2: Mini bank runs in autumn 2008 in Bosnia and Herzegovina, Montenegro and Serbia

A significant run on the banks was observed in Bosnia and Herzegovina in October 2008 on deposits both in domestic and in foreign currency totalling more than EUR 400 million. Over a single month households withdrew around 13% of their sight deposits and almost 11% of their saving and time deposits. The bulk of the deposit run came from the reduction of foreign currency deposits, representing more than 80% of total deposits. However, the Central Bank of Bosnia and Herzegovina was quite successful in calming down the situation by quickly reducing minimum reserve requirements and by making public statements about the solidity of the Bosnian financial sector. During 2009, the citizens' trust in the banking system was further redeemed, also helped by the reaction of some banks which opted to increase savings rates on deposits with longer maturity and/or offered new savings products with the aim of reverse the decline in depositing rates and extending their maturity portfolios.

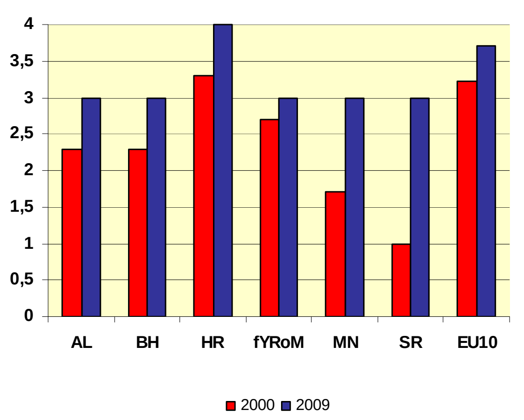
In October 2008, Montenegro also faced a sudden withdrawal of deposits from the banking sector worth almost EUR 158 million, of which 83% from citizens' accounts. In this case, the run came also as a reaction to the liquidity problems encountered at the time by the second-largest bank. By December 2008 total deposits further decreased, albeit at a slower pace, totalling 64% of GDP, compared with 74% in September. In 2009, the situation gradually improved, with a similar pattern of lengthening the maturity of deposits. The Central Bank of Montenegro has estimated that of the total amount of reduction in deposits registered from September 2008 to March 2009, over 60% was used to settle credit obligations.

The run on the banks was also the first reaction to the crisis in Serbia, albeit with a limited effect thanks to the ample liquidity in the banking system; a result of tight monetary policy. In October 2008, the banking sector endured a loss in household deposits amounting to almost EUR 900 million (one sixth of total deposits) and the dinar lost more than 10%. While the impact for the economy was limited as the National Bank of Serbia promptly allowed a greater share of required reserves to be held in dinars, all deposits withdrawn mainly by concerned households were recovered during 2009.

banking sector reform index for the transition economies (the indicator does not exist for Turkey and, for the time being, for Kosovo) that measures progress achieved against the standards of industrialised market economies. All countries increased their score between 2000 and 2009, some of them substantially. While Croatia reaches a score of 4 ([20]) in 2009, even above the EU-10 average, all other countries achieve a score of 3 which the EBRD characterises as "substantial progress in the establishment of bank solvency and of a framework for prudential supervision and regulation; full interest rate liberalisation with little preferential access to cheap refinancing; significant lending to private enterprises and significant presence of private banks".

([20]) Indicating "significant movement of banking laws and regulations towards BIS standards; well-functioning banking competition and effective prudential supervision; significant term lending to private enterprises; substantial financial deepening".

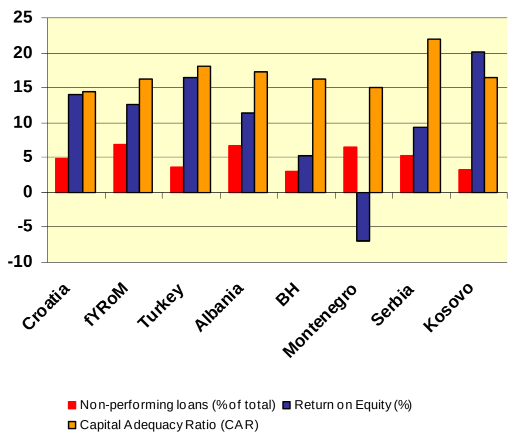
Graph 2.14: **EBRD index on banking sector reform**



Source: EBRD Transition Reports

The banking sector followed an overall conservative business model, i.e. financing credits by deposits which is characterised by relatively low loan-to-deposit ratios when compared to EU-10 countries. The sector was also well capitalised with the capital adequacy ratio ranging between 15% in Croatia and 28% in Serbia in 2008, slightly below previous years' figures but still well above the 12% minimum rate as required by the Basel II Accord. The share of non-performing loans to total loans was overall fairly stable before the crisis and stood at levels around 5% in 2008, except in the former Yugoslav Republic of Macedonia and Albania. Return on equity was comparatively high in the candidate and potential candidate countries, reaching double-digit territory in all countries except Bosnia and Herzegovina, Montenegro and Serbia in 2007. Profitability and liquidity indicators of the banking sector in candidate and potential candidate countries were comparable with those of the EU-10.

Graph 2.15: **Banking prudential indicators (2008)**



Source: National Central Banks

Since the beginning of the crisis, the contraction of economic activity jeopardised the capability of the private sector to repay its debt in a timely manner. The ratio of non-performing loans to total assets followed an upward trend in 2008 and 2009 in all countries. The worst deterioration of asset quality measured by this ratio was recorded in Albania, Montenegro and Serbia. So far, the banking sector has remained well capitalised in all countries, but the situation could change if the real sector were to further deteriorate significantly.

The slowdown in credit growth and particularly the deterioration in asset quality lowered banks" profitability in all countries. The banking sector in Montenegro suffered losses in 2008 and in the first quarter of 2009 while in Albania, Bosnia and Herzegovina and the former Yugoslav Republic of Macedonia banks’ profitability reached a very low level. In contrast, the return on assets and equity of the banking sectors in Croatia, Kosovo and Serbia did not fall dramatically, while in Turkey it actually increased.

Box 2.3: The European Banking Coordination Initiative

The "European Banking Coordination Initiative" (EBCI), formerly known as the "Vienna Initiative" was first launched in the context of the IMF and EU support packages for Hungary, Romania and Latvia, and then extended to the two potential candidate countries that also needed external support in order to weather the crisis, namely Bosnia and Herzegovina and Serbia. The Initiative was meant to ensure that foreign parent banks would keep their exposure in the countries of the region following the concern that a decline in foreign funding would have a direct negative impact on financing available for the domestic economy. The Initiative was jointly driven by the EBRD, the IMF and the European Commission, bringing together international financial institutions, home and host supervisory authorities and the bank groups themselves. Home governments undertook to provide deposit insurance and liquidity support for banks regardless of ownership, parent banks engaged in a – voluntary and not legally binding – commitment to refinance and recapitalise their subsidiaries in the countries concerned, if needed. This also served in a way as a reassurance for the IMF that the money it pumped into these economies would not be directly transferred abroad. It is worth noting that, when looking at the exposure of foreign-owned banks, the performance of the two countries included in the Initiative does not substantially deviate from that of the other candidate and potential candidate countries. In fact, according to data compiled under the EBCI ([1]), exposure towards Serbia was broadly maintained in 2009 (1.6% increase in December 2009 compared to December 2008) while it fell by 9% in Bosnia and Herzegovina. In the case of Bosnia and Herzegovina, banks have experienced difficulties in maintaining their commitments due to the lack of credit demand and of available instruments to invest excess liquidity (e.g. lack of government treasury bills and bonds). However, international banks reduced their exposure towards many emerging market economies in late 2008 and at the beginning of 2009, according to BIS data. Such a decline occurred also in the old EU Member States, even though it happened earlier there throughout 2008.

([1]) In the bilateral commitment letters of the parent banks exposure is defined as: (i) outstanding balances on all loans and other debt instruments owed by entities in the countries concerned minus balances owed by the parent to financial institutions in these countries; (ii) the parent's deposits with financial institutions in these countries less deposits of financial institutions with the parent; and (iii) all forms of capital provided by the parent to the subsidiary, including subordinated debt and hybrid instruments.

2.3. MACROECONOMIC POLICY REACTIONS

2.3.1. Monetary and exchange rate policy

Unlike Turkey, the Western Balkan economies have a high degree of euroisation. In more concrete terms, in five of them the exchange rate arrangement is based on the euro as an external anchor. While Montenegro and Kosovo rely on the euro as their official legal tender, Bosnia and Herzegovina runs a currency board arrangement and Croatia and the former Yugoslav Republic of Macedonia have tightly managed floats, which are de facto almost fixed. In these countries of former Yugoslavia this was not so much the outcome of an initial policy choice, but more the result of the preference of domestic economic agents, which triggered this policy response from their authorities (see European Commission 2008). While this external anchor eliminates the possibility of an independent domestic monetary policy, it contributed positively to macroeconomic stabilisation in these economies. On the other hand, Albania and Serbia (like Turkey) have opted for the alternative of letting their currencies float independently, even though in the case of Serbia discretionary interventions by the central bank can be observed from time to time.

Monetary authorities in candidate and potential candidate countries reacted in broadly similar ways to the crisis. However, the scope of possible monetary reactions was determined by the choice of the exchange rate regime which, in fact, restricted the available instruments in fixed regimes basically to steering the liquidity situation by changing minimum reserve requirements. The

Box 2.4: **Exchange rate developments of the floating currencies during the crisis**

The floating currencies (Albania, Serbia and Turkey) recovered some of the lost ground in the second and third quarters of 2009 after they had depreciated against the euro between the last quarter of 2008 and the first quarter of 2009. Most notably, Serbia and Turkey experienced strong tensions in the foreign exchange markets during that period and their central banks took measures to stabilise the exchange rate. The Serbian dinar was under increasing pressure, losing close to 17% vis-à-vis the euro during the fourth quarter of 2008. At end-October 2008, the National Bank of Serbia had increased its policy rate by 200 basis points to 17.75% to stem rising inflationary pressures but also to help support the local currency. The National Bank also intervened repeatedly in the interbank foreign exchange market until February and thereby managed to reduce the rate of depreciation to around 5% in the first quarter of 2009. As tensions on the foreign exchange and inflation dampened, the National Bank of Serbia reversed course during 2009 and reduced its policy rate in several steps by 775 basis points to 10% in November 2009. In December, the National Bank intervened again in the foreign exchange market for the first time since February.

The Turkish lira lost more than a quarter of its nominal value against the euro in 2008, and another 15% in the first quarter of 2009. Thereafter, the pace of depreciation slowed significantly. The Central Bank of Turkey focused on alleviating the potentially harsh impact of the global financial crisis on the domestic economy. In this respect, it delivered sizeable cuts in policy rates while providing liquidity support to facilitate the smooth operation of credit markets. The Monetary Policy Committee has cut interest rates by a cumulative amount of 1025 basis points since November 2008, thereby lowering policy rates more than any other emerging market central bank since the intensification of the global crisis. The Central Bank also eased some regulations governing loan classification and provisioning requirements.

The Albanian lek remained relatively stable vis-à-vis the euro in the fourth quarter of 2008, but came under increasing pressure in early 2009 leading to an overall depreciation of about 10% in nominal terms in the course of 2009. In view of subsiding inflationary pressures and as a reaction to the crisis, the Bank of Albania reduced its basic policy rate in two steps of 50 basis points each in January and October to 5.25% and started providing unlimited liquidity to banks at its current policy rate in early 2009.

"floaters" had on the one hand the full set of monetary policy instruments available, but on the other hand also had to deal with depreciation pressures. Albania, Serbia and Turkey, used their possibilities to different degrees, benefitting also from easing inflationary pressures during 2009 as a result of international price developments (see Box 2.4 below). Initially, policy rates were hiked in all the countries that dispose of this instrument ([21]) to stem pressures on the foreign exchange market, except in Albania ([22]). In the second stage, policy reactions included lowering of the policy rates, injecting liquidity in the markets and easing conditions for refinancing operations. It can be stated that the reactions were overall in line with international policies aimed at mitigating the impact of the crisis on the domestic economies. In Bosnia and Herzegovina, Montenegro and Serbia liquidity tensions in the banking sector were quite pronounced in the month of October 2008 (see Box 2.3 above), but also in these cases central banks managed well overall to smoothen the liquidity situation and to restore confidence in financial markets.

Central banks in countries with fixed exchange rate or managed peg regimes initially reacted by relaxing reserve requirements, thereby injecting liquidity into the economy. The Croatian National Bank, in addition, had to intervene twice in the foreign exchange market in order to stabilise the exchange rate, which had slightly depreciated during the crisis. The National Bank of the former Yugoslav Republic of Macedonia even raised interest rates for short-term central bank bills from

([21]) In the officially euroised economies Kosovo and Montenegro and in Bosnia and Herzegovina with its currency board policy rates cannot be set independently.

([22]) The policy response in Albania consisted of a cut in rates in line with international developments.

7% to 9% in order to neutralise the impact of the government's expansive fiscal policy. The Central Bank of Bosnia and Herzegovina increased the liquidity of the banking system by lowering the minimum reserve requirement rate in several consecutive steps between November 2008 and April 2009. The currency board has continued to function well and proved its stability under difficult circumstances. Because Kosovo and Montenegro rely on the euro as their sole legal tender, the room for autonomous monetary policy is even more limited than in the countries with a fixed currency peg. Both central banks resorted to administrative and prudential measures to smoothen the effects of the crisis.

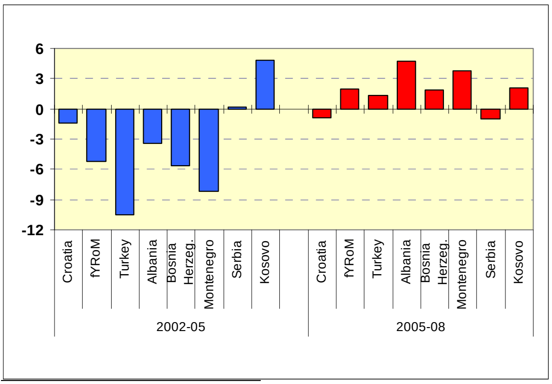
2.3.2. Fiscal developments

Pre-crisis developments

Fiscal developments in pre-accession countries displayed a very different time profile over the pre-crisis period. The year 2005 seems to represent a turning point. While in the early years of the decade fiscal consolidation appeared as a key priority to regain fiscal space, supported by the external anchor of IMF programmes in most pre-accession countries and cyclical tax revenue buoyancy caused by large absorption booms, fiscal consolidation was relaxed towards the end of the period. The IMF anchor was not adequately replaced by a domestic one. After having gone down markedly in the previous years, government expenditure increased in 2005-2008 in Albania, Bosnia and Herzegovina and Montenegro, fuelled mainly by booming public investment. Turkey, which went through the most drastic and effective fiscal consolidation in the years that followed the 2001 crisis, reducing the ratio of general government expenditure by more than 10 GDP percentage points between 2002 and 2005, also relaxed its efforts towards the end of the period.

Croatia and Serbia, however, followed a different route: they had not gained such margins of manoeuvre in the years 2002-2005 and, as both have heavy governments (general government expenditure represents 48% of 43% of GDP, respectively), they remained highly constrained in the years 2005-2008 and did not to the same extent relax their fiscal stance (in the case of Serbia, public salaries and pensions increases granted in 2008 mainly accrue in the following years).

Graph 2.16: **General government expenditures, variation in GDP %**

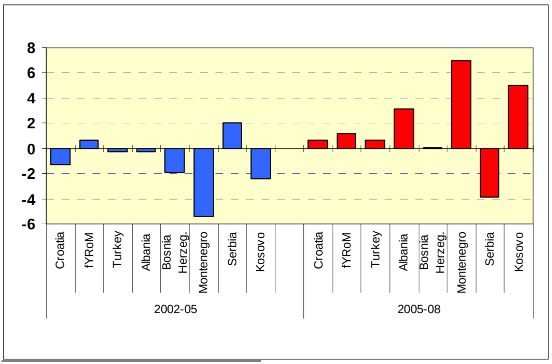


Source: IMF

The case of Kosovo is also a specific one as state building (that started already under UNMIK administration before the declaration of independence in 2008) led to a rise in expenditure over the two sub-periods, which was also influenced by a shift of public capital expenditure from the donor financed Public Investment Programme (off budget) to the budget. Bosnia and Herzegovina stands as an outlier in pre-accession countries since its large consolidated government – the consolidated general government expenditure ratio amounts to about 50% of GDP and is the highest in the region – weighs heavily on private sector growth.

On the revenue side, a different paradigm can also be observed over the two sub-periods. Except in Serbia, the overall tax burden decreased as a percentage of GDP (taking the general government revenue ratio as a proxy of the tax burden) in the years 2001-2005, albeit less sharply on average than general government expenditure. Conversely, fiscal revenues increased in the years 2005-2008, partly as a result of high tax elasticities in the boom and tax reforms that broadened the fiscal base as in Albania and Montenegro. Only Serbia witnessed a declining fiscal revenue ratio over the second sub-period.

Graph 2.17: **General government revenues, variation in GDP %**



Source: IMF

The outcome of these expenditure and revenue trends reveals a material improvement in fiscal balances over the first sub-period in view of fiscal consolidation achievements, and a less favourable evolution over the second one. While the degree of immediate correlation that can be observed between fiscal and current account balances in pre-accession countries has generally been a weak one over the recent years, largely due to the larger size of the private sector's savings and investment gap (see section 3.1.1), the broad profile of fiscal and current account developments is rather similar in cross-country average terms over the two sub-periods, suggesting that the recent fiscal loosening may indeed have added to external imbalances.

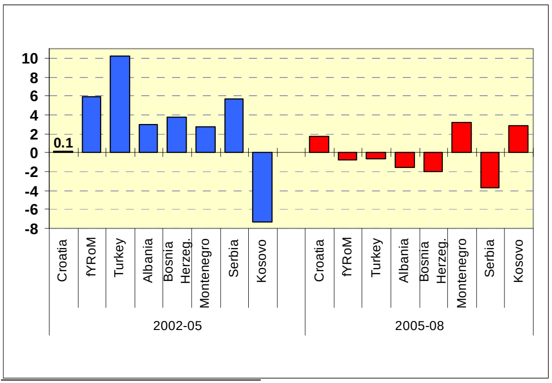
Table 2.12: **General government balance, % of GDP**

	2002	2003	2004	2005	2006	2007	2008
Croatia	-4,1	-6,1	-4,8	-4,0	-3,0	-2,3	-2,3
fYRoM	-5,6	0,2	0,7	0,2	-0,5	0,6	-0,9
Turkey	-11,4	-8,9	-5,4	-1,2	-0,6	-1,6	-1,8
Albania	-6,6	-4,5	-5,1	-3,6	-3,2	-3,8	-5,2
BH	-3,7	-1,4	-1,1	0,1	2,2	-0,1	-1,9
Montenegro	-4,5	-4,8	-2,7	-1,7	2,1	6,5	1,5
Serbia	-4,5	-3,3	-0,3	1,2	-1,6	-1,9	-2,5
Kosovo	4,4	1,6	-4,5	-2,9	2,3	7,0	0,0

Source: National sources

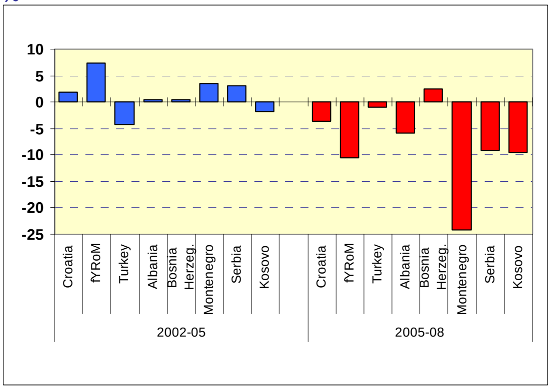
The considerable improvement in 2002-2005 also enabled public debt to come down to broadly sustainable levels. An acceleration in GDP growth – and in Montenegro and Serbia the full benefits of the Paris and London Club sovereign debt rescheduling – also contributed to favourable public debt dynamics and a decline in the public debt ratios in the last three years preceding the crisis. Albania is at present the most indebted country with public debt (53% of GDP end-2008) only coming down slowly due to its still high deficits. Elsewhere ([23]), public debt ratios came down below 40%. In the case of Turkey, the public debt improvement was spectacular, with public debt falling from 78% in 2001 to 39.5% in 2008, on the back of high economic growth and primary balance surpluses over a number of years.

Graph 2.18: **General government balance, variation in GDP %**



Source: IMF

Graph 2.19: **Current account deficit, variation in GDP %**



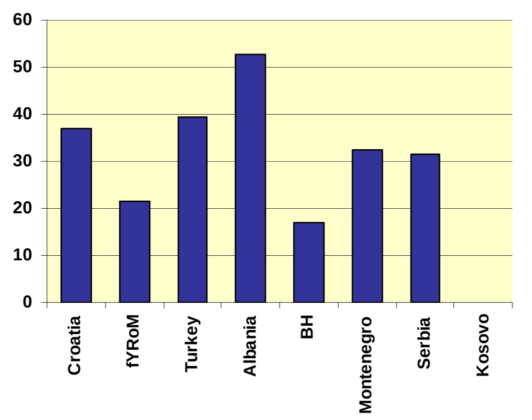
Source: IMF

Overall, the years 2005-2008 saw a relaxation of the fiscal stance and expansionary fiscal policies, mainly through increases in expenditures fed by booming revenue. The loss of the external IMF anchor in most countries towards the end of the period contributed to this but is not the only factor since this fiscal loosening can also be observed in

([23]) No public debt is reported for Kosovo in the following Graph 2.20. However, Kosovo started to assume in 2009 obligations on World Bank credits that were until 2008 serviced by Serbia. Paris Club and London Club debts related to projects located in Kosovo have at this stage not been transferred to Kosovo and are currently still serviced by Serbia as the sovereign borrower of record.

Albania, Turkey, and to a lesser extent the former Yugoslav Republic of Macedonia that had an IMF programme until 2008. Illusions as to the sustainability of the fiscal position – with fiscal revenues fuelled by high tax elasticities in the boom period – also played a role. This expansionary ([24]) fiscal position in the years 2006-2008 has, in tandem with increasing external imbalances, contributed to exacerbating the pre-accession countries' exposure to the crisis. As they entered into the crisis towards the end of 2008, most of them continued to plan budget revenue growth levels in 2009 that eventually turned out unrealistic and required a fully reassessed fiscal stance.

Graph 2.20: **Public debt 2008, % of GDP**

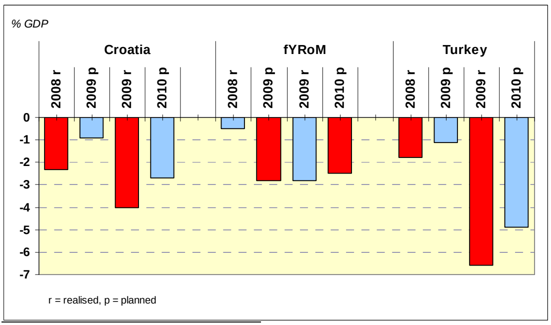


Source: IMF

- Fiscal policy options were very limited in all countries, also in view of the expansionary policies conducted in previous years. While external imbalances remained high, albeit adjusting rapidly in the course of the current crisis, fiscal policies had to support the much-needed adjustment process. The crisis-related decline in public revenues and limited prospects for realising privatisation proceeds reduced the scope for financing fiscal expenditures and deficits, while access to foreign financing via the international capital market became more difficult.

- Any room for increasing taxes was often limited by an already high degree of taxation in several countries (particularly Croatia, Serbia and Bosnia and Herzegovina); further tax increases could have adversely impacted medium-term growth prospects.

Graph 2.21: **Fiscal balances: the impact of the crisis**



Source: National sources

Fiscal policy response to the crisis

Unlike in Turkey, which has an autonomous monetary and exchange rate policy, the onus of the macro-economic policy mix in the Western Balkans lies very much on fiscal policies. In the context of the recent dramatic deterioration of the global economy, the appropriate policy responses had to take into account the specific situations in each affected country. In the case of the Western Balkan countries important common elements were:

Under such heavy constraints, the crisis tested the ability of national authorities in the Western Balkans to deliver macro-economic and fiscal policy responses commensurate to the challenge and to the magnitude of the adjustment needed. Overall fiscal deficits widened significantly throughout the region under the impact of the crisis, despite some rebalancing efforts.

Croatia was the first country among the Western Balkans to be affected by – and to react to – the deteriorating economic situation. In March 2009 a budget rebalancing was approved, followed by two other exercises in the course of the year. Cuts in spending and measures to compensate for falling revenues (VAT increase, special tax on income) have been adopted. Overall, in spite of these fiscal tightening measures, the budget deficit was

([24]) We prefer to describe the fiscal stance as "expansionary" rather than "pro-cyclical", given that cyclicality is difficult to assess in catching-up economies. The assessment of output gaps and of cyclically adjusted fiscal positions remains difficult, and highly sensitive to the method that is being used.

expected to increase to -3.3% of GDP, instead of 0.9% as initially planned.

Other countries in the region followed suit. Serbia had initially considered mainly fiscal stimulus policies in response to the crisis and adopted a sizeable stimulus package for the economy. However initial budget assumptions for 2009 rapidly became unsustainable. Following weak revenue performance in early 2009 Serbia approved in March measures to reduce the looming high fiscal deficit in the context of the first review of the IMF stand-by arrangement that had been approved in January 2009, initially only on a precautionary basis. Despite these measures, the planned fiscal deficit was revised down to 3% instead of the initially planned 1.7%, with this revision backed by a number of tightening measures to prevent the deficit from reaching its expected trajectory of 6% of GDP at the time. Serbia missed the first semester fiscal deficit target, however, as the economic downturn turned out to be even more severe than expected in March. In the context of the second review of the IMF programme the 2009 fiscal deficit target was revised for a second time, down to 4.5% of GDP.

In July 2009 Bosnia and Herzegovina reached a comparable agreement with the IMF on a new stand-by arrangement (of some EUR 1 billion), allowing a sizeable increase in the consolidated general government deficit from a close to balanced planned level (-0.1% of GDP) down to 4.7% of GDP ([25]). Even this, however, also required significant fiscal measures with large expenditure cuts in the State and both entities, to prevent the deficit from reaching much higher levels.

In the former Yugoslav Republic of Macedonia, the government significantly increased spending in the last two months of 2008, turning an accumulated fiscal surplus of about 2% of GDP into an end-year deficit of 0.9% of GDP. In mid-2009 and in autumn, the government adjusted revenue and spending targets by nearly 10% compared to the initial budget proposal, while maintaining the 2009 deficit target at 2.8% of GDP.

([25]) In the context of the first review of the Stand-by Arrangement in November, the deficit target for 2009 was further reduced to 5.2% of GDP.

Montenegro initially adopted in 2008 a fiscal stimulus package of up to 9.5% of GDP with increases in capital spending that were later downsized, and cuts in rates of personal income tax and social contributions. A full budget rebalancing was decided in early July, targeting a revised budget deficit of 2.6% by end-2009 (instead of 0.1% initially), and backed by a reduction of expenditure, notably goods and services consumption as well as capital investments. The preliminary outturn shows a budget deficit of 3.5% of GDP in 2009. The adopted 2010 budget forecasts a further widening of the deficit to 4.3% of GDP.

Albania was the last country to adjust its budget. The stance over the year 2009 remained expansionary, due to higher expenditure up by some 8% on the back of increased public infrastructure spending, with public revenue growing at a much slower pace of 3.6% over the same period. The Parliament approved in September a revised budget increasing the deficit to 6.4% of GDP and again in December to 6.9% of GDP, instead of 4.2% that had been planned. The 2010 budget projects a budget deficit reduction to 3.9% of GDP by lowering expenditure, expected to decline by 2.3 percentage points of GDP.

Conversely, in Turkey fiscal space gained after several years of drastic fiscal adjustment in the years 2002-2006 allowed a broader fiscal response with a number of stimulus measures whose cost is estimated at around 2.1 % of GDP. The authorities did not rebalance the 2009 budget, but allowed public spending to grow according to the adopted budget, while revenues underperformed. This altogether on the back of negative GDP growth (around -6% in 2009) led to a sizeable fiscal deficit of the central government of about5.5% of GDP.

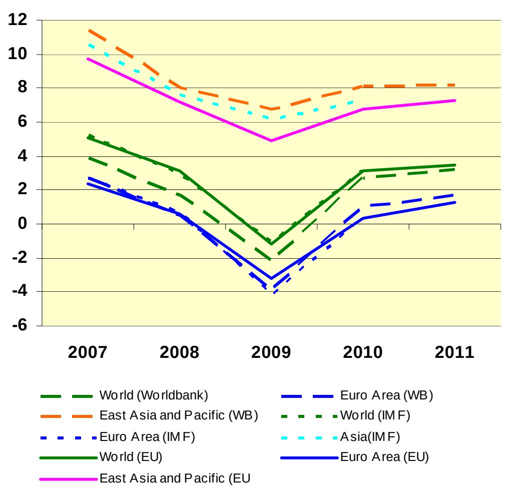
Turkey delayed discussions on a new IMF programme and instead adopted in September a medium-term programme aiming at gradual fiscal consolidation in order to reassure markets on the medium-term sustainability of the current expansionary fiscal stance. Details on ways to achieve this have not been disclosed, and the fiscal and macro-economic assumptions on which the programme is based appear on the optimistic side. Even though a new fiscal rule is considered for adoption towards the end of the period, it has not been defined yet.

3. PROSPECTS AND CHALLENGES

The dramatic shock to the global economy in 2008 and 2009 makes it difficult to predict the near and medium term prospects of the global economy in general and of the pre-accession countries in particular. However, in recent months there has been a growing consensus that the trough of the global downturn seems to be over and that the main question now is how quickly the recovery will come and how steep it will be.

Global growth will probably be driven by strong output growth in Eastern and South Eastern Asia, and particularly in China, India, and Indonesia. This region appears to have weathered the financial market 'storm' rather well and seems to be still driven by a rapid catching-up process. In many of the more developed economies the recovery will probably be more subdued, as the costs of addressing the financial crisis are likely to weigh on medium-term growth.

Graph 3.1: **Global growth outlook, %**



Source: World Bank, IMF, EU Commission

In their latest reports, the IMF, the World Bank and the OECD ([26]) expect global output to have dropped by some 1-2% in 2009, compared to growth rates of 4-5% in previous years. However, for 2010 and 2011 international forecasts expect an increase in global output of around 3% annually.

Asia is likely to remain the most dynamic region. In 2008-2009, output growth decelerated to around 5-7% in 2008-2009, following previous rates in excess of 10%. In 2010 and 2011, most international forecasts expect a return to growth rates of around 7-8%. The impact of the financial crisis on Europe appears to have been fairly strong, with a decline in output of around 5% on average. For 2010-2011, most international institutions expect a rather moderate recovery, of around 1-2% annually. As a result, the big differences in growth rates between emerging Asia and the more advanced economies are likely to persist.

3.1. PROSPECTS FOR THE REGION

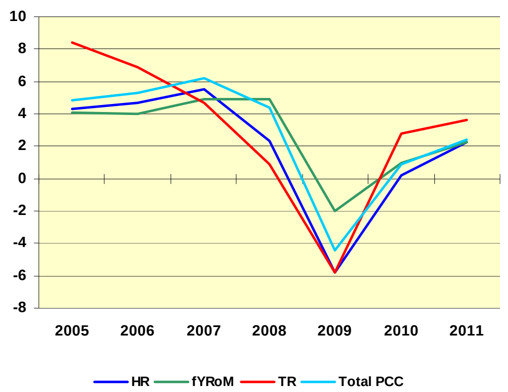
As outlined before, the region's strong growth in the middle of the decade in most countries was to a large extent driven by external factors, foreign financed investment (and, to some extent, consumption) and exports. In the near term, this stimulus effect is likely to be less pronounced. As a result, the overall growth dynamics will probably be lower than in the 5-7 years before the crisis. Countries will have to rely more on endogenous growth factors, and competition for external funds might become harder.

Overall, most international forecasts expect a moderate recovery of the region, following the growth pattern of the region's main trading partner, Europe. Low growth is foreseen for 2010, (at around 1-2%), and a stronger recovery is expected in 2011 as external demand strengthens, driven by continued strong growth in emerging Asia and an improved situation in the US and the EU.

With the widespread expectation of a moderate recovery, current account deficits which had declined markedly in 2009 are likely to increase again as a result of weak international demand for the region's exports and accelerating domestic demand. The European Commission's Autumn 2009 forecast expects a deterioration of the current account deficits in Croatia and Turkey in 2010 and 2011, mainly as a result of rising domestic demand.

([26]) IMF (2009): World Economic Outlook, November 2009, World Bank (2010): Global Economic Prospects, January 2010, European Commission (2009).

Graph 3.2: **Growth outlook for candidate and potential candidate countries**



Source: European Commission

As a result of slower economic dynamics and tighter financial markets of the region's main trading partners, capital flows from these countries to the pre-accession countries are also likely to decline. Lower trade and current account deficits thus would not necessarily indicate an improved international financing position, but could also be the result of a more difficult economic environment where attracting the necessary foreign capital to modernise the region's capital stock is becoming an ever greater challenge.

3.2. A NEW GROWTH PARADIGM?

A challenging question is whether a new growth paradigm may be needed in the pre-accession economies, in order to ensure a more dynamic and sustainable real convergence. Taking a more "structural" view of the efficiency and sustainability of the pre-crisis growth pattern, this section recalls the available evidence on the determinants of growth in the pre-crisis period and goes on to outline the possible building-blocks of a new growth model. As the onus of the growth adjustment should come from improving domestic savings, investment and labour force participation, these key aspects are given specific consideration.

The low level of domestic savings recorded in most of the pre-accession economies before the crisis points to a growth pattern that is highly dependent on foreign savings and external financial inflows. Such a development strategy is vulnerable to a sudden turnaround in capital flows, possibly spilling over into a domestic financial and real sector crisis. In particular, in the case of ample international capital flows which do not necessarily reflect real savings but rather an artificial credit expansion, the risk of a sudden withdrawal of capital becomes more tangible. In addition, the real appreciation of the domestic currency which accompanies capital inflows may adversely affect the competitiveness of the tradable sector. Some observers ([27]) recommend vigilance as regards the openness of financial accounts and contend that recent evidence shows that the countries which are growing most rapidly are those which have relied less on foreign capital and allowed less smoothing of consumption. However, this may not be an appropriate answer in the case of pre-accession economies which have had to redouble their efforts to integrate economically and financially in the European Union.

At the same time, other policy channels remain open to the pre-accession economies in order to attract capital flows that can enhance the competitiveness and the productive capacity of their economies, while moderating those which would fuel domestic and external imbalances. First of all, the improvement of the business environment would boost potential returns in the private sector and could shift the composition of investment in the direction of the tradable sector and exports. A more responsive business environment, better prioritisation of public expenditures and the removal of distortions in taxation would gradually support an increase in the savings ratio of the private sector while at the same time enhancing the attraction of FDI. Fiscal policy can also play a key role - increasing the structural balance of the public sector as the most direct route to enhancing domestic savings. Secondly, policy makers need to give priority to implementing appropriate regulatory and prudential frameworks, in particular in the monetary and financial area, so as to discourage

([27]) See for example Rodrik (2009) or Prasad, Rajan and Subramanian (2007). The latter have found that non-industrial countries that have relied more on foreign finance have not grown faster in the long run. The reason seems to be the low capacity of these economies to channel foreign capital to productive uses given their undeveloped financial systems, weak market institutions and proneness to exchange rate overvaluation when faced with such inflows.

excessive leveraging and to cap the growth of financial assets at levels compatible with reasonable risk-taking. Given the insufficient contribution of labour input to growth, the acceleration of labour market reforms is of particular importance. A vigorous policy action should put growth on a more sustainable and dynamic path, allowing the pre-accession economies to cover the still large gap in living-standards relative to the EU average.

3.2.1. Determinants of growth

Borys, Polgar and Zlate (2008) have found in an analysis for the ECB that, during the period 1997-2006, the main driver of convergence in the pre-accession countries (except for Turkey) was total factor productivity (TFP) growth, followed by capital deepening. At the same time, labour has contributed only marginally to economic growth. By applying the same growth accounting exercise to the new Member States (EU-10), the lower TFP contribution in the latter can be noted, particularly in the period 2002-2006. This implies that, on the one hand, a significant part of TFP growth has been largely due to eliminating the inefficiencies of the former socialist economies and that a decline to levels seen in the more advanced economies can be expected in the future. On the other hand, this provides further proof that transition in the Western Balkan pre-accession countries was generally slower than in the EU-10 and that some of them still have an unfinished reform agenda. Turkey's factor contribution to growth was more balanced during the period 1980-2005 as documented by Altug, Filiztekin and Pamuk (2007). During this period, which was characterised by several crises and economic volatility, but which also corresponded to a process of economic liberalisation for Turkey, the contribution to growth from TFP, capital and labour was 28%, 38% and 34% respectively.

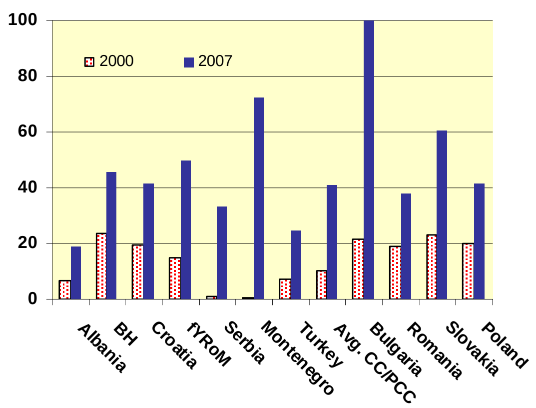
Therefore, the sustainability of the real convergence process in the pre-accession countries (perhaps less so in Turkey) is challenged by the need to improve labour utilisation and enhance capital accumulation, while continuing to ensure TFP growth.

With regard to labour input, the ECB analysis finds that labour productivity has improved in all pre-accession countries relative to the Euro Area, mainly owing to the expanding shares of more productive sectors in total output and the decline of total employment in the transition process. However, labour utilisation has improved only marginally; suggesting that the labour force thus released has either had difficulties in re-skilling in order to occupy new jobs or has found new employment in the large informal economy. Labour indicators in the region show much higher rates of unemployment and lower employment rates than in the EU, in particular in Bosnia and Herzegovina, the former Yugoslav Republic of Macedonia and Montenegro.

The pre-accession economies have undergone a process of capital deepening in recent years, as witnessed by the increase of the investment ratio from less than 20% of GDP in 2000 to over 25% of GDP in 2008. This compares relatively favourably with the EU-27 average, but is much lower than that of other fast growing economies in East Asia or among the new Member States. Handjiski (2008) found that capital accumulation in the pre-accession countries is low compared to world averages, but – more importantly – private investment is also quite low. Private investment as a share of GDP hovered around 17% until 2003 and only started to pick-up afterwards. This is significantly below the levels for the EU-10, even when compared with levels achieved there in the earlier years of transition. Moreover, construction accounts for more than half of gross fixed capital formation in most of the pre-accession countries, except for Turkey and Serbia, indicating that the impulse to the tradable sector from the investment side is relatively weak. Another vulnerability of the pre-accession countries relates to their very low national savings rates (which in recent years have barely exceeded 10% of GDP on average), resulting in fairly high external imbalances. This is very different from the pattern in high-growth economies, which typically save a large share of their income, and where a national savings rate in excess of 20-25% is not unusual. Of the countries in the region, only Albania recorded a savings rate in this range.

The rise in the investment ratio which occurred in the pre-accession countries after 2000 was only partly driven by the increased contribution of net FDI, since a substantial part of it actually represented a transfer of assets and was not seen as investment in national accounts terms. The ratio of net FDI to gross fixed capital formation rose from around 8% on average during 1990-2000 to more than 40% in 2006 and around 30% in 2008. Even then, it represented only about half of the level recorded in Bulgaria. However, after 2000 the indicator compared favourably with some new Member States, such as Romania and Slovakia. A relative improvement took place particularly during 2006-2008, including in Turkey which benefitted from a notable opening after the 2000/01 crisis. This reflected both the increased attractiveness of the region to foreign capital and the overall surge in international capital flows. Private capital formation rose faster in those economies which managed to attract more FDI, as was the case in Montenegro. At the other end of the spectrum, Albania – the country which had been least successful in attracting FDI – saw its private investment-to-GDP ratio decline slightly over the period.

Graph 3.3: **Stock of FDI, % of GDP**



Source: UNCTAD, World Investment Report 2009

The stock of foreign direct investment increased significantly in the pre-accession countries between 2000 and 2007. At the beginning of the period it averaged about 10% of GDP, representing less than half of the level recorded in some of the new Member States, such as Bulgaria, Romania, Slovakia and Poland. As of 2007, the pre-accession countries had increased their stock of FDI to more than 40% of GDP, which compares with the lowest levels recorded in the new Member States. However, this figure masks big differences among the pre-accession countries – Montenegro has accumulated more than 70% of GDP in FDI inflows, whereas Albania, Turkey and, to some extent, Serbia are very far behind their peer group. In addition, foreign investment has been concentrated in only a few sectors, of which financial intermediation was the most prominent. In most of the pre-accession countries, with the notable exception of Turkey, foreign ownership in the banking sector exceeds 80%. Handjiski (2008) reveals that, although a relatively large share of foreign investment went into manufacturing (in excess of 20% in countries like Croatia, the former Yugoslav Republic of Macedonia, Serbia and Turkey), this compares unfavourably with countries like Slovakia, which were more successful in seizing the opportunities that emerged from off-shoring. Apart from being concentrated in a few sectors - primarily services (non-tradable) - foreign investment in the pre-accession countries has also been mostly associated with the privatisation process. Green-field investment has been fairly marginal, which means that only a fraction of the FDI contributed directly to gross fixed capital formation. Large parts of the FDI came in the form of privatisation proceeds in the banking or telecom sectors.

3.2.2. Structural reforms fostering domestic saving and investment

Structural reforms that enhance domestic saving, investment and capital accumulation would need to be at the heart of a new growth model for the pre-accession economies. Compared to the new Member States, transition reforms did not pick up momentum in the region until later (in the late 1990s in the Western Balkans and after the 2000/2001 crisis in Turkey). Good progress was achieved in some areas, but reforms were not implemented consistently among all sectors and countries. In many countries, there were advances in privatisation and in the improved functioning of markets and the business environment. As regards the liberalisation of network industries, the restructuring of state-owned enterprises and upgrading of the capacity and efficiency of the public sector, including the judiciary, progress has been rather mixed. Overall, despite the gradual advances, pre-accession countries are still trailing the new Member States and other fast-growing emerging economies.

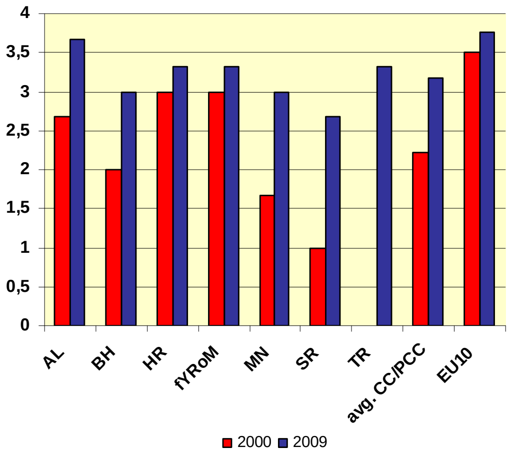
In the Western Balkans, in addition to the late start of privatisation, it took longer on average to achieve a critical mass of privatised companies in the economy. In some economies, however, the private sector's share of output has reached a relatively high level ([28]), particularly in Albania, Croatia, the former Yugoslav Republic of Macedonia, Montenegro and Turkey. In a number of countries, on the other hand, the privatisation process was not managed properly and failed to boost enterprise restructuring and modernisation. Even in the more advanced economies, there are still sectors where privatisation and enterprise restructuring have progressed only slowly, such as the shipbuilding sector in Croatia, the oil sector in Albania and the energy sector in Turkey. Bosnia and Herzegovina - in particular the Federation of Bosnia and Herzegovina - and Serbia need to step up the privatisation process, given the potential efficiency gains that will flow from this process. Moreover, quasi fiscal deficits remain significant in the state-owned enterprises sector, as well as the budget subsidies which keep unviable companies alive. Although the crisis makes the prospects for privatisation worse, Montenegro and Turkey may serve as a good example of how to persevere with the privatisation process even in a difficult environment.

The liberalisation of network industries is deeper in telecommunications, but less so in the energy and utilities sector. Besides the fact that the weight of the private sector is generally insufficient in the production and distribution of energy, the restructuring of companies is less advanced than in the EU10. Again, Serbia, Bosnia and Herzegovina, but also Montenegro, appear to be the laggards in this respect. Both in terms of enterprise restructuring and large-scale privatisation, Albania has made significant progress during 2000-2009 and moved very close to the EU-10 average performance.

The improvement of the business environment was important in the region not only for productivity and welfare reasons, but also in order to enhance the flexibility of labour and product markets and, by implication, macroeconomic stability.

([28]) [28] Private sector share in GDP (%) according to EBRD's Transition Report 2009 – 75% in Albania, 60% in Bosnia and Herzegovina, 70% in Croatia, 70% in the former Yugoslav Republic of Macedonia, 65% in Montenegro, 60% in Serbia and 70% in Turkey.

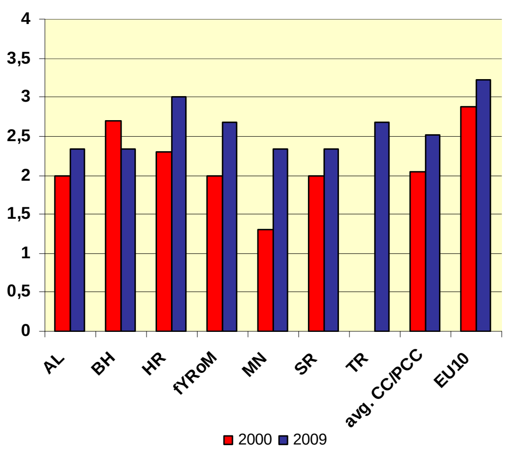
Graph 3.4: **EBRD index of large scale privatisation**



Source: EBRD Transition Reports

Given that many countries in the Western Balkans have abandoned an "independent" monetary policy as a tool to manage inflation and the exchange rate, the adequate functioning of markets together with fiscal prudence are key in ensuring macro-stability and external competitiveness. The World Bank's ranking on the ease of doing business shows that from 2005 to 2009 the overall average ranking for the pre-accession countries improved by around 15 places to 80th out of 183 countries. This still compares unfavourably with the average ranking of the EU-10 countries hypothetically placed in 46th position. In addition, there are big differences among the pre-accession economies. Only the former Yugoslav Republic of Macedonia has risen to a position comparable to that of the new Member States, whereas Montenegro, Turkey, Albania and Serbia are in the top half of the ranking. At the same time, the assessment of the business environment in Croatia, Kosovo and Bosnia and Herzegovina is very poor compared to other investment destinations. Bosnia and Herzegovina is not only bringing up the rear of the entire group; it has also fallen significantly in the ranking. Further evidence is provided by the results of the 2009 EBRD-World Bank Business Environment and Enterprise Performance Survey (BEEPS). One of the striking results of the last round of BEEPS was the big increase in respondents who perceived infrastructure as an obstacle to doing business relative to the previous round of BEEPS in 2005.

Graph 3.5: **EBRD index of infrastructure reform**

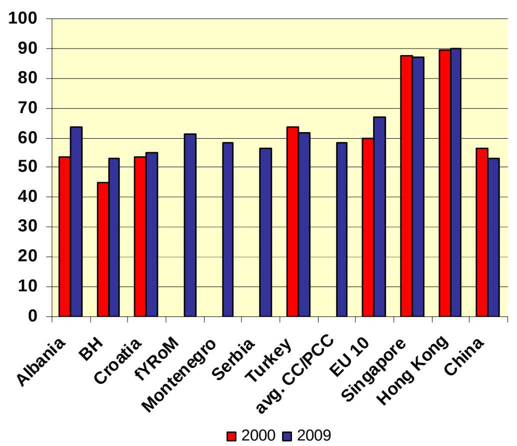


Source: EBRD Transition Reports

One of the most important shortcomings as regards the business environment relates to rigidities in the labour market, which make it extremely difficult to hire. Overall, the most acute problems are the difficulty of hiring (rigidity of fixed-term contracts, minimum wages, etc.) and redundancy costs (severance payments expressed in weeks of salary). Other significant challenges relate to the areas of dealing with construction permits, closing a business and paying taxes. Also in the fields of registering property and enforcing contracts, which are closely related to the smooth functioning of an independent judiciary, the potential candidate countries need to redouble their efforts. The situation is noticeably better in the candidate countries, and particularly in Turkey. The best score is obtained for "getting credit", thus reflecting the progress made in privatising and restructuring the banking sectors in the region, which are now predominantly foreign-owned. Turkey's banking sector is still mostly under domestic ownership, but it appears to be weathering the crisis very well, due to its better regulation and supervision which led to more prudent risk-taking in the boom years. The improvement of infrastructure has progressed, but according to the EBRD transition index, pre-accession countries are not yet at the level attained by the new Member States. The state of physical infrastructure, particularly roads, remains inadequate in most of the economies, except for Croatia and Turkey. This is a major constraint on cross-border trade and growth.

As proven by economic theory and some empirical examples of sustained rapid catching-up of economies in emerging Asia, Europe or Latin America, economic freedom is an important ingredient of sustainable economic progress. The economic freedom index compiled by the Heritage Foundation ([29]) provides a quantified overview of the process of economic transition and liberalisation that is taking place in the pre-accession countries. They score rather poorly in terms of economic freedom – Albania, Turkey and the former Yugoslav Republic of Macedonia qualify as "moderately free" economies, whereas Montenegro, Serbia, Croatia and Bosnia and Herzegovina are regarded as "mostly un-free" economies. On average, they score worse than the EU-10, although the difference is only striking in the case of Serbia, Croatia and particularly Bosnia and Herzegovina. While the countries score well in terms of fiscal and trade freedom, they lag some way behind in terms of property rights, freedom from corruption, labour freedom and size of government. Other areas where the countries perform relatively well are monetary and business freedom.

Graph 3.6: **Index of Economic Freedom- Scores**



Source: Heritage Foundation

One element which supports the structural reform agenda could also be the establishment of a strong domestic fiscal anchor. Fiscal rules of this kind can reassure markets about the quality of domestic

([29]) See the 2009 index of economic freedom at http://www.heritage.org/index/

governance and sustainability of the economic situation. Many countries throughout the world have adopted explicit fiscal commitments to strengthen discipline, reduce discretionary elements and to relieve short-term political pressures on policymakers. Domestic anchors may be customised according to each country's specific situation and could bridge the gap towards EU membership. A prerequisite for sound fiscal policies is the existence of properly functioning public financial management systems, including internal control and the external auditing of budgets. Greater focus should be placed on improving the quality of public finances in order to enhance the efficiency of available resources. This includes the size of the public sector, the sustainability of public finances and the composition and efficiency of revenue and expenditure systems. To enhance the countries' resilience, improvements in the prioritisation of budget expenditure and revenue measures should play a key role, in particular by better targeting those measures which contribute to the functioning of the market economy and to raising the countries' competitiveness.

Despite recent strides, the pre-accession countries are still lagging behind the new Member States when it comes to structural reforms, and some of them – such as Bosnia and Herzegovina, Serbia and Kosovo – clearly need to speed up reforms if they want to unlock their potential for economic catching-up. The crisis has further slowed reform efforts in most of these economies. The other countries have tried to counter the economic impact of the crisis, also by continuing the planned structural reforms in order to make their economies more flexible in the corrective phase of the business cycle or to improve their fiscal position through privatisation revenues. Some of them – Montenegro, Albania and Turkey – have even been successful in the privatisation of important economic units in the energy sector, despite dwindling international capital flows and low appetite for emerging-market risk.

However, major bottlenecks remain with regards to the functioning of labour markets, including large and inefficient public sectors in most of the pre-accession countries ([30]), inadequate infrastructure, an unfinished privatisation and restructuring agenda, particularly in Bosnia and Herzegovina, Kosovo and Serbia, and a dysfunctional judiciary which does not ensure adequate protection of property rights, enforcement of contracts and freedom from corruption. Economic theory and empirical experience underline the fact that a sustainable catching-up process of the economy and an increase in the standard of living are only possible through an increase in labour productivity. In turn, this is the result of applying more innovative technologies, allowing for an efficient market allocation of the factors of production and accelerating capital accumulation. Renewed efforts are necessary in the pre-accession economies in order to remove as many obstacles to saving and investment as possible, in a predictable economic environment that protects private property rights. A new growth model based on these ingredients would strengthen the resilience of the pre-accession countries to domestic and external shocks and allow for a sustainable catching-up process.

3.2.3. Labour market challenges

The main labour market indicators show a weak performance of labour markets in the Western Balkans and Turkey, as compared to those in the EU. Additionally, after years of relatively good economic performance - characterised by strong growth with very low job creation – almost all candidate and potential candidate countries recorded a pronounced slowdown in growth in 2009, with significant job losses occurring across many countries and sectors. Except for the former Yugoslav Republic of Macedonia and Albania, unemployment has risen significantly in the past year. Rising unemployment is gradually becoming a key challenge in all countries under observation, as it is part of the vicious circle of decline into which these economies are locked. Breaking out of this cycle will depend essentially on the course of the global economy.

([30]) In particular in Croatia, Bosnia and Herzegovina, Serbia and Montenegro, where public spending varied between 40 and 50% of GDP in recent years.

Table 3.1: **Labour market**

	Unemployment rate		Employment rate	
	1999	2008	1999	2008
Albania	18,4	12,8	55,7	56.4*
BH	39,4	23,4	n.a	40,7
Croatia	14,5	8,4	53,2	44,5
fYRoM	32,4	33,8	40,2	37,3
Serbia	14,5	13,6	58,3	53,3
Montenegro	19,3	16,8	39,2	43,2
Turkey	7,7	11,0	50,8	45,9
Average C/PC	20,9	17,1	49.6**	64.3
EU 27	9,1	7,0	61,8	65,9
Euro area	9,3	7,5	60,4	66,0

* 2007
*** Excluding BH*

Source: Eurostat, Thomson-Reuter, National Sources

Employment rates are particularly low – between 40 and 50% - and have shown particularly significant falls in the past decade (except for Montenegro). This picture compares unfavourably with EU Member States, which enjoyed a rising and significantly higher employment rate of about 65% in 2009.

The situation in some sub-categories, particularly amongst low-skilled workers, young people and women, is even more worrying. Specific measures focusing on these categories, which are often hardest hit by the crisis, have been part of the crisis response mounted by some countries. More specifically, Croatia has targeted low-skilled and older workers, while Turkey focused new measures on women and unemployed persons under 30 years. At least in some of the pre-accession economies, such as Turkey and Kosovo, demographic trends may play a major role, with a rising share of young population. The absorption of this young labour force requires a steady rate of employment creation and an adequate match between the demand and supply of skills.

A skills mismatch and inadequacies in education appear to be amongst the root causes of the imbalances (see, among others, European Training Foundation, 2007). The breakdown of educational attainment across employment and unemployment can provide a rough indicator of where there is an excess supply of individuals with different levels of education. In Croatia the share of unemployed workers with vocational education is 30% compared to the share of employed workers, which is 22%, indicating a positive excess supply in this educational group. There is also an excess supply of workers with secondary technical education, and with secondary general education, although to a lesser extent than for the vocational group. This pattern of excess supply in the middle range of educational attainment is repeated in the former Yugoslav Republic of Macedonia, in Serbia and in Montenegro. In Turkey, the situation appears to be more complex, which could be due to the major inadequacies in education.

In addition, standard labour market indicators do not seem to provide enough information when it comes to describing the functioning and performance of labour markets in these countries. There are at least two main reasons for this. First, the concept of employment covers a number of different situations with respect to the quality of jobs in terms of income, access to social protection, rights and working conditions, and the degree of precarity. For example, the relatively high level of employment in Albania hides a large percentage of employment in subsistence agriculture, informal wage employment and self-employment. In general, the extent of regular employment seems to be much lower in the candidate and potential candidate countries (although its share of total employment differs among countries and regions). An in-depth analysis of employment status in selected Western Balkan states using data from the Living Standards Measurement Study surveys (LSMS) shows that formal employment rates range from 14% in Albania to 24% in Bosnia and Herzegovina and 37% in Serbia. Second, the private segment of the labour market is characterised by instability, high mobility and a high degree of precarity. Many people have developed lifestyles (and/or survival strategies) with multiple employment statuses, and readily switch between employment, unemployment and inactivity and between formal and informal activities as opportunities become available. As a result, the time spent in different labour market statuses is often short, and this makes it difficult to assess the functioning of the labour market using standard labour market indicators.

The Balkans are a source of labour outflow to the economies of Western Europe in general. As a result, there is a significant dependence on remittances in most countries (except for Turkey, and to a lesser extent, Croatia) in order to both sustain consumption and alleviate high levels of unemployment at home. Remittances secure a substantial share of the income for many households, but they also lead to higher reservation wages, which may be another reason for the low employment rates.

More radical structural reforms, targeting the labour market in particular, and institutional change are essential for the candidate and potential candidate countries to tackle labour market rigidities and rebuild their competitive position in order to secure a successful convergence of their income towards the levels in the EU Member States. This is particularly important since the – in some cases rapidly – ageing population is likely to increasingly affect labour productivity, and hence, long-term growth. At the same time, such restructuring is likely to involve the replacement of older, less sophisticated production technologies with newer technologies that require higher skill levels among the workforce, which may lead to an even more pressing need for adequate education.

ANNEX 1

Savings and investment balances

Table A1.1:

Croatia

	2005	2006	2007	2008
Current Account Balance	**-5,6**	**-7,0**	**-7,6**	**-9,5**
Savings	19,0	19,1	18,6	18,1
Investment	24,6	26,1	26,2	27,6
General government	**-3,5**	**-3,0**	**-2,5**	**-1,4**
Savings	-0,1	0,1	1,3	0,7
Investment	3,4	3,0	3,7	2,0
Private sector	**-2,1**	**-4,0**	**-5,1**	**-8,1**
Savings	19,1	19,0	17,3	17,4
Investment	21,2	23,1	22,5	25,6

FYR Macedonia

	2005	2006	2007	2008
Current Account Balance	**-2,6**	**0,9**	**-7,2**	**-13,1**
Savings	14,4	19,1	13,0	11,4
Investment	17,0	18,2	20,2	24,5
General government	**0,2**	**-0,5**	**0,6**	**-0,9**
Savings	3,8	2,5	4,3	4,1
Investment	3,6	3,0	3,7	5,0
Private sector	**-2,8**	**1,4**	**-7,8**	**-12,2**
Savings	10,6	16,6	8,7	7,3
Investment	13,4	15,2	16,5	19,5

Turkey

	2005	2006	2007	2008
Current Account Balance	**-4,6**	**-6,1**	**-5,9**	**-5,5**
Savings	16,5	16,2	16,0	14,8
Investment	21,0	22,3	21,8	20,3
General government	**-0,6**	**1,2**	**-1,0**	**-2,2**
Savings	2,7	4,6	2,4	1,6
Investment	3,3	3,4	3,4	3,9
Private sector	**-4,0**	**-7,3**	**-4,8**	**-3,3**
Savings	13,8	11,6	13,6	13,2
Investment	17,7	18,9	18,4	16,4

Albania

	2005	2006	2007	2008
Current Account Balance	**-8,9**	**-6,6**	**-10,6**	**-14,8**
Savings	20,0	22,5	18,6	16,9
Investment	28,9	29,1	29,2	31,7
General government	**-3,6**	**-3,2**	**-3,5**	**-5,5**
Savings	1,1	2,4	2,4	3,3
Investment	4,7	5,6	5,9	8,8
Private sector	**-5,3**	**-3,4**	**-7,1**	**-9,3**
Savings	18,9	20,1	16,2	13,6
Investment	24,2	23,5	23,3	22,9

Bosnia and Herzegonvina

	2005	2006	2007	2008
Current Account Balance	**-17,3**	**-7,9**	**-10,4**	**-14,9**
Savings	10,1	13,0	14,7	11,1
Investment	27,4	20,9	25,1	26,0
General government	**2,4**	**2,9**	**1,3**	**-2,0**
Savings	9,3	9,0	8,2	5,7
Investment	6,9	6,1	6,9	7,7
Private sector	**-19,7**	**-10,8**	**-11,7**	**-12,9**
Savings	0,8	4,0	6,5	5,4
Investment	20,5	14,8	18,2	18,3

Kosovo

	2005	2006	2007	2008
Current Account Balance	**-9,8**	**-10,3**	**-10,2**	**-16,3**
Savings	13,4	14,7	16,8	13,7
Investment	23,2	25,0	27,0	30,0
General government	**-3,0**	**2,4**	**7,0**	**0,0**
Savings	2,0	5,8	9,8	7,6
Investment	5,0	3,4	2,8	7,6
Private sector	**-6,8**	**-12,7**	**-17,2**	**-16,3**
Savings	11,5	9,0	7,0	6,1
Investment	18,3	21,7	24,2	22,4

Montenegro

	2005	2006	2007	2008
Current Account Balance	**-8,5**	**-24,7**	**-29,4**	**-30,1**
Savings	9,2	0,7	-1,4	-3,1
Investment	17,7	25,4	28	27
General government	**-2,3**	**2,7**	**6,4**	**0,5**
Savings	1,8	7,8	13,1	7,9
Investment	4,1	5,1	6,7	7,4
Private sector	**-6,2**	**-27,4**	**-35,8**	**-30,6**
Savings	7,4	-7,1	-14,5	-11,0
Investment	13,6	20,3	21,3	19,6

Serbia

	2005	2006	2007	2008
Current Account Balance	**-8,3**	**-9,4**	**-14,9**	**-17,9**
Savings	12,6	12,5	7,1	4,7
Investment	20,9	21,9	22,0	22,6
General government	**0,9**	**-1,6**	**-2,0**	**-2,5**
Savings	3,5	2,2	2,2	2,0
Investment	2,6	3,8	4,2	4,5
Private sector	**-9,2**	**-7,8**	**-12,9**	**-15,4**
Savings	9,1	10,3	4,9	2,7
Investment	18,3	18,1	17,8	18,1

Source:

ANNEX 2

Fiscal policy support vs. tightening responses

	Fiscal support measures	Fiscal adjustment measures, budget rebalancing exercises
Candidate countries		
Croatia	Introduction of a temporary subsidy for a 32-hour working week. The subsidy will cover the difference in social security contributions and up to 10% of the wage difference. It amounts to around 0.06% of GDP. Increase in agricultural subsidies, in particular for milk farmers. This amounts to around 0.1% of GDP.	Three budget revisions, as revenues continued to drop significantly, to contain the budget deficit at 3.3% of GDP, compared to an initial much lower deficit target of 0.9%. Without those adjustments, the deficit would have been considerably higher. Cuts in spending (in particular public sector wages, material expenses, sick leave reduction, categorical benefits, transfers and subsidies to railways) and measures to compensate for falling revenues: special tax on income, suspension of pension indexation, VAT increase of one percentage point, and increases in excise duties and administrative fees. The government issued a EUR 750 million Eurobond in May and a USD 1.5 billion loan in November.
The former Yugoslav Republic of Macedonia	In Nov. 2008, the authorities presented ten measures, claiming an effect of 5-6% of GDP. Most measures (some 3-4% of GDP) appear to have no impact on the deficit, as they consist of rebates and write-offs of unpaid social security contributions. The remaining part (about 2% of GDP) consists mainly of a further lowering of taxes on profits and agricultural incomes.	Three revisions, cutting revenue and expenditure estimates by nearly 10%, but maintaining the -2.8% deficit target. On the revenue side, issue of EUR 175 million in Eurobond.
Turkey	Several stimulus packages, including the provision of zero-interest loans for SMEs, a tax break for local investors in equities, and inducements for Turks to repatriate savings held offshore. A crisis package adopted in mid-March supported domestic demand by cutting taxes, including VAT, on the sale of cars, office furniture, IT, houses and machinery used by SMEs for a period of three to six months. Investment Incentive Scheme and an Employment Package to combat the effects of the economic crisis.	The authorities have not rebalanced the 2009 budget, but allowed public spending to grow according to the adopted budget, while revenues underperformed. The central budget deficit would increase from 1.1% of GDP in the adopted budget to a projected 6.6% of GDP under the Medium-Term Economic Programme.

	According to the most recent estimate by the authorities, the discretionary anti-crisis measures amount to around 2.1% of GDP in 2009.	
Potential candidate countries		
Albania	In mid-March, the government raised guarantees on bank deposits to EUR 25,000. The new guarantee covers more than 80% of all bank deposits.	A supplementary budget in September revised the deficit to 6.4% and again in December to 6.9% of GDP, instead of 4.2%.
Bosnia and Herzegovina		April 2009: FBIH budget revised to reflect the planned borrowing to cover the 2008 budget deficit. Rebalanced budget was approved in June in the RS, lowering expenditure by 4.2%. July: additional tightening agreed upon agreement on new IMF programme, with spending cuts on salary and pension increases and other current expenditure. On the revenue side, excise duties on cigarettes, coffee and alcohol increased as of 1 July 2009. December: Both the Federation and the RS adopted revised 2009 budgets in order to comply with IMF requirements and bring the expected deficits closer to the levels agreed in the programme. In the Federation it was the third revision, decreasing both expenditures and revenues by some EUR 30 million. In the RS it was the second one, leaving the overall envelope unchanged but moving budget allocations on both the revenue (higher non-tax revenues offsetting lower taxes and foreign loans) and the expenditure side.
Montenegro	Stimulus package up to 9.5% of GDP end-2008: increase in capital spending later downsized in the 2009 budget. In addition, rates of personal income tax and social contributions as well as other fees for businesses further reduced. Reduction of electricity prices for the most vulnerable categories of the population, as well as for small and medium-sized enterprises (SMEs). Adoption of emergency measures to protect the banking system, including: full guarantee of deposits, lowering reserve requirements, and credit support	Budget rebalancing in early July, targeting a revised budget deficit of 2.6% by end-2009. Reduction of expenditures, in particular goods and services consumption as well as capital investments. Possibility, should the economic situation further deteriorate before the end of the year, to cut wages by 10% in the public service. On revenue side, excise duties raised on tobacco and fuels. Loans subscribed from Erste Bank and Credit Suisse amounting to 4.3% of GDP.

	for up to one year to distressed banks.	
Serbia	Public sector salaries increased in the course of 2008 and pensions raised by an extraordinary 10% in November in addition to the regular 4.13% increase. Stimulus package for the economy, providing EUR 100 million of direct and EUR 195 million of indirect government subsidies for concessional bank loans to enterprises and households. Until end-August, EUR 791 million of loans with preferential conditions approved through this scheme.	A major budget rebalancing with significant cuts in expenditure was agreed following the IMF March 2009 mission that led to a major revision of the programme, with a deficit target of 3% of GDP. A second revision, increasing the deficit up to 4.5% of GDP, was agreed following the September IMF second review mission.
Kosovo (UNSCR 1244)	None (not necessary in view of still positive growth in 2009).	Exceptional PTK (telecom incumbent) dividend of EUR 200 million increased revenue and led to better than expected outturn in 2009 (deficit -1.1% of GDP, assuming PTK dividend is above the line, otherwise the turnout is worse than initially foreseen (-6.2% of GDP with PTK dividend below the line).

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ABBREVIATIONS

AL Albania

BALT Baltic Countries

BEEPS Business Environment and Enterprise Performance Survey

BG Bulgaria

BH Bosnia and Herzegovina

BRICS Brazil, Russia, India and China

CAR Capital Adequacy Ratio

CC Candidate countries

CEEC Central and Eastern European Countries

EBCI European Banking Coordination Initiative

EBRD European Bank for Reconstruction and Development

ECB European Central Bank

EL Greece

EU European Union

EUR Euro

FBiH Federation of Bosnia and Herzegovina

FDI Foreign Direct Investment

FX Foreign exchange

fYRoM The former Yugoslav Republic of Macedonia

GDP Gross domestic product

GNP Gross national product

GVA Gross Value Added

HR Croatia

IMF International Monetary Fund

KO Kosovo under United Nations Security Council Resolution 1244

LSMS Living Standards Measurement Study surveys

MN Montenegro

NFA Net Foreign Assets

NMS New Member States

NPL Non-performing loans

OECD Organisation for Economic Co-operation and Development

OSCE Organisation for Security and Co-operation in Europe

PCC Potential candidate countries

PPPs Public-private partnerships

PTK Post and Telecommunication of Kosovo J.S.C.

RO Romania

ROA Return on Asset

ROE Return on Equity

RS Republika Srpska

SEE South-East Europe

SMEs Small and Medium sized Enterprises

SR Serbia

TFP Total Factor Productivity

TR Turkey

UN United Nations

UNCTAD United Nations Conference on Trade and Development

UNMIK United Nations Interim Administration Mission in Kosovo

UNSCR United Nations Security Council Resolution

USD United States Dollar

VAT Value Added Tax

WB World Bank

WBs Western Balkans

WTO World Trade Organisation

Y/y Year-on-year