EUROPEAN ECONOMY

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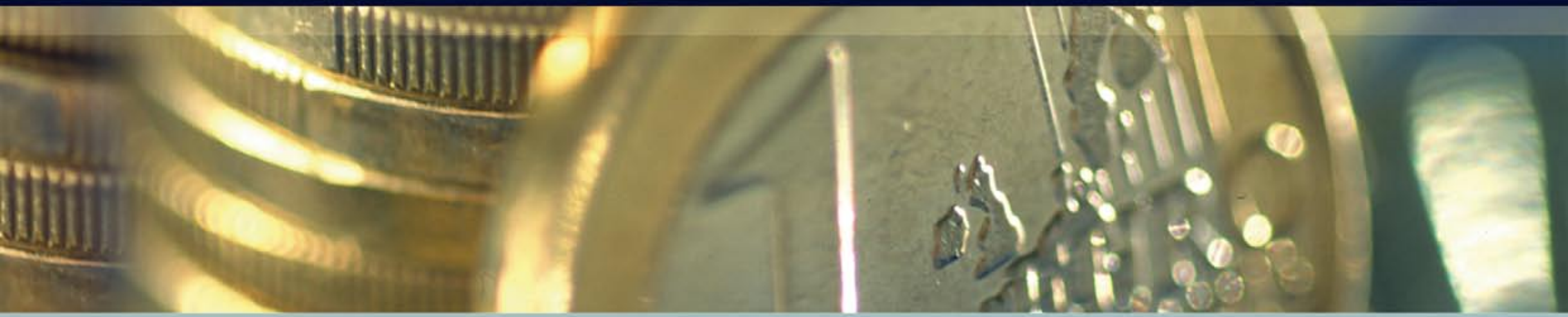

Promoting prosperity and stability: The EMU anchor in candidate and potential candidate countries

Directorate-General for Economic and Financial Affairs

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OVERVIEW

The current issue focuses on the EU and primarily the EMU anchors for promoting stability and growth in the candidate and potential candidate countries. It is widely acknowledged that the EU accession prospect and the gradual insertion in the Economic and Monetary Union policy framework represent valuable instruments for the sustainable development of the aspiring members. For that purpose, the two papers published in this report – "The Euro as external anchor in the Western Balkans" and "Fiscal consolidation in candidate and potential candidate countries" – represent an attempt of assessing the economic and policy benefits, as well as some of the main potential challenges posed by the euro external anchor and the EMU framework for the candidate and potential candidate countries.

The first paper takes stock of the extensive use of the euro in the Western Balkans, in all its traditional functions emphasized by the literature (trade invoicing currency, reserve currency, exchange rate and monetary anchor, financial currency and parallel cash). Naturally, the highest attention is granted to the de facto euroisation of the economies in the region and the widespread pegging of domestic currencies to the euro.

The paper describes the historical context in which the break-up of the former Socialist Federal Republic of Yugoslavia contributed to the use of the DM and later the euro as external anchors for policy making and/or parallel currencies. It shows that together with other stabilisation policies and structural reforms, which were partly inspired by the EU accession process or the EMU policy framework, the euro anchor has supported a rapid and sustainable disinflation process, an improvement of fiscal policies and a deepening of trade and financial integration with the EU. Finally, in the recent period, economic growth became more robust and sustainable. Before concluding, the paper reviews the challenges posed by the use of external anchors and parallel currencies in the region. In the context of rapid real convergence and institutional transformation, euro-pegging and increasing borrowing in foreign currency may add to macroeconomic risks in case of inadequate domestic policies. The note argues in favour of accelerating structural reforms that would enhance the flexibility of goods and labour markets and conducting sound fiscal policies so that the candidate and potential candidate countries can take full advantage of the EU and euro anchors.

The second paper covers the Western Balkans and Turkey which are all either candidate (Croatia, the former Yugoslav Republic of Macedonia, and Turkey) or potential candidate (Albania, Bosnia and Herzegovina, Montenegro and Serbia) countries. The European Union has since 2001 established an economic and fiscal surveillance procedure with candidate countries. More recently, in 2006, the Commission extended some of the main features of this economic and fiscal surveillance to potential candidate countries. These two procedures are briefly presented in the paper, as well as the other channels of influence established between the EU and those countries that are expected to accede in the medium or long-term horizon. The European agenda and priorities are also made clear to the candidate and potential candidates in, respectively, Accession and European "Partnerships" that establish the key steps that need to be taken in order to join the EU.

The paper shows that fiscal consolidation has overall taken place in the region with remarkable improvements in fiscal positions, in particular in the former Yugoslav Republic of Macedonia, Turkey, Bosnia and Herzegovina and Montenegro. Over the period, fiscal balances improved markedly, but this improvement was achieved with different patterns, a combination of reduced expenditure and increased revenue in candidate countries, whereas in potential candidate countries buoyant revenues were the main source of improved balances. Additional fiscal space for private sector development was thus created owing to reduced public deficits but only in a more limited number of cases due to a reduced share of general government spending. In the absence of estimates of output gaps and structural balances it remains however difficult to fully assess the extent to which these improvements were purely cyclical – a feature which may have more limited relevance for catching up economies than for EU economies - or also of a structural nature. Recently, however, a number of countries, in particular Albania, Bosnia and Herzegovina and Serbia, have relaxed fiscal discipline, thus jeopardizing some of their achievements of the recent period.

Overall, while it would be hazardous to draw a direct link between surveillance and EU objectives on one side and, on the other side, fiscal consolidation achievements, the combined -even distant- EU accession prospect and narrow margins of manœuvre as regards the macro-economic policy mix appears to have had a strong incentive role in convincing candidate and potential candidate countries' fiscal authorities to pursue overall prudent fiscal policies. IMF programmes also contributed to fiscal discipline, but in the recent period most of them have come to an end. The recent worsening of the international environment and of these countries' external imbalances is expected to put an additional onus on fiscal policies to deliver some of the adjustments that can hardly be attained through the monetary policy channel.

These papers were prepared by staff within the Unit “Economic affairs of candidate countries and Western Balkans. Economic policy related to enlargement” in the European Commission’s Directorate-General for Economic and Financial Affairs - Directorate for International Economic and Financial Affairs. The first paper was drafted by Mihai Macovei and co-authored by Christophe Pavret de la Rochefordière (subchapters 2 and 4.2), Frank Kohlenberger (subchapters 3.1, 3.2, 3.4 and 3.5), Dirk Verbeken (subchapters 4.1, 4.4, 4.5, 4.6 and 4.7) and Bernhard Böhm (subchapter 5.1). The second paper was drafted by Christophe Pavret de la Rochefordière with contributions from Frank Kohlenberger and Ana Sabič from the Croatian National Bank at the time of her secondment to the European Commission.

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Part I

The Euro as external anchor in the Western Balkans

1. INTRODUCTION

After its creation in 1999, the euro quickly established itself as the second main international currency. In the Western Balkans, which have a clear European perspective and whose economies are well integrated with the EU, the euro is not only the first international currency, but also represents an important instrument for economic stabilisation and growth. These economies are highly euroised and in five of them (out of seven) the current exchange rate arrangements are based on the euro as an external anchor. The paper presents historical trends in the use of the euro in the region, the macro-stabilisation role indirectly or directly played by the euro in the Western Balkans[1] and the challenges faced by these economies in the future. In the context of the ongoing rapid real convergence against the background of insufficiently strengthened institutions and a relatively low flexibility of markets or mobility of factors of production, external competitiveness and financial stability could come under pressure.

The second section provides a description of the historical context in which the break-up of the former Socialist Federal Republic of Yugoslavia took place and of the factors that led to the widespread use of the DM and later the euro as external anchors for policy making and/or as parallel currencies. It concludes that the use of the DM/euro as a stabilising anchor was not so much the outcome of an initial policy choice, but more so of the preference of domestic economic agents which triggered this policy response from their authorities.

The role played by the euro as international currency in the Western Balkan countries is examined in the third section which looks at the traditional functions emphasized by the literature on international currencies (trade invoicing currency, reserve currency, exchange rate and monetary anchor, financial currency and parallel cash). With many of these countries exhibiting a high degree of *de facto* euroisation, special emphasis will be put on the euro's wide use as domestic financial currency (currency of denomination of domestic bank loans and deposits) and as parallel currency.

The fourth section assesses improvements in terms of economic stability and performance brought about by the official and de facto pegs against the DM and later the euro in the Western Balkans, together with stabilisation policies and structural reforms that are partially inspired by the EMU policy framework. The widespread use of the DM/euro in the region played an important role in stabilising and avoiding a complete collapse of the economies during the initial stages of the Yugoslav crisis, while later it facilitated the trade and financial integration with the EU. These improvements include the rapid and sustainable disinflation process, the amelioration of the fiscal stance as the onus of the policy-mix fell on the conduct of a sound fiscal policy in the absence of monetary policy instruments, the reduction of exchange rate uncertainty and transaction costs contributing to rapidly growing trade with the EU, the rapid financial deepening and ultimately the more robust and sustainable growth.

Before concluding, the paper reviews the challenges posed by the use of external anchors in the region. The fifth section takes stock of the large external imbalances and rapid financial deepening prevailing in the Western Balkans and tries to assess whether the current policies are sufficiently fostering macroeconomic stability by preserving external competitiveness. The recent turbulences on international financial markets and the signs of an accompanying credit crunch raise new concerns in this respect. The conclusions of the paper underline that the euro anchor and the EU membership prospects play a positive macroeconomic stabilisation role for the Western Balkan economies. The positive economic performance from recent years tends to confirm that the preconditions for further catching-up and improvement of living standards are in place. However, the outcomes will depend very much on policy responses to current and future challenges. This requires a stronger focus on sound fiscal policies and an acceleration of structural reforms so that these countries can reap the full benefits of the monetary stability imported from the euro zone.

1 The following economies are covered: the candidate countries Croatia and the former Yugoslav Republic of Macedonia, the potential candidate countries Albania, Bosnia and Herzegovina, Montenegro and Serbia and Kosovo (UNSCR 1244).

2. HISTORICAL BACKGROUND

The 1990s were years of turmoil in the Western Balkans. The effects of three simultaneous crises, namely the breaking up of the Socialist Federal Republic of Yugoslavia ([1]), war among or within successor republics, and the dismantling of the planned economy based on social ownership altogether led to GDP dropping sharply to pre-1990 levels in all the former Yugoslav republics. In Croatia, it came down by end 1993 to 60% of its 1990 level. In Bosnia and Herzegovina, devastated by civil war, and in Serbia, notably in Kosovo, the shock was even harsher, with a drop of GDP to less than 45% of 1990 levels. At the turn of the millennium, the legacy of the 1990's in the Western Balkans had become a difficult and challenging one.

The Yugoslav federation's dismantling led to a fragmentation of a previously unitary economic space. National currencies were introduced in Croatia in 1991 (the Croatian dinar, replaced by the kuna in May 1994) and in the former Yugoslav Republic of Macedonia in 1992 (the denar). Bosnia and Herzegovina introduced its own dinar in 1992, and, following the 1995 Dayton Peace Agreement, established a currency board arrangement and the convertible Mark (KM). While these currencies were initially introduced at par with the Yugoslav dinar, this quickly changed given the instability of the latter and the emergence of hostilities in the region. Montenegro, the smaller of the two member states of the Federal Republic of Yugoslavia, unilaterally declared the Deutsche Mark parallel legal tender to the Yugoslav dinar in November 1999, in a period of high tension between Belgrade and Podgorica. In 2001 the Deutsche Mark became sole legal tender, replaced by the euro in 2002. In Kosovo, UNMIK introduced in 1999 the DM, followed by the euro as of 2002, as the main currency in use with legal tender status.

Newly established monetary institutions faced a tough job in establishing their credibility and authority. Inflation had already reached high levels in the Socialist Federal Republic of Yugoslavia in the 1970s and 1980s. In the period 1971-1991, the average annual inflation rate had been around 70%, and further accelerated towards the end of the period, with monthly inflation numbers of more than 50% in 1989. The situation aggravated under war conditions in the early 1990's with the monetisation of public deficits and wide-scale corruption. Hyper-inflation in Serbia-Montenegro (at the time still "the Federal Republic of Yugoslavia") in 1993-1994 destroyed any possible remaining confidence in the national currency, reaching the record level of 313 million percent in the sole month of January 1994 and led to the closure and liquidation of numerous enterprises, including large banks. In Croatia, one of the wealthiest countries of the region, inflation reached 1,500% in 1993, prompting severe adjustment measures which reduced it to 2% in 1995.

The growing monetary "chaos" led to a situation characterized in the economic literature as "original sin", whereby a country cannot borrow in its currency abroad and can only borrow short-term at home, with wide ranging and long lasting effects challenging attempts to restore economic stability. Moreover weak newly established central banks, with inexperienced and poorly equipped supervision departments were in a number of cases unable to prevent the eruption of severe financial crises. The collapse of pyramid schemes in Albania and the former Yugoslav Republic of Macedonia in the late 90's challenged macro-economic and financial stability and had a high price in terms of foregone growth.

Economic agents reacted with distrust towards domestic currencies and financial institutions resulting in a wide scale recourse to cash holdings in foreign currencies, mainly the DM. Remittances denominated in DM or other European currencies became a major source of revenue – somewhat dampening the hardship of the crisis and were largely held in cash. This vote of non-confidence against home currencies and local banks was certainly also influenced by the legacy of measures taken by the former Yugoslav authorities, which back in 1991 had

([1]) As mentioned previously, the paper looks at all the economies originating in the former Socialist Federal Republic of Yugoslavia except for Slovenia, which is a Member State, and including Albania as another potential candidate country. Turkey, another candidate country, is not covered because it does not share a similar historical and economical starting point.

frozen – de facto confiscated citizens' foreign currency holdings in domestic banks, estimated at the time at some DM 7 billion. While a number of schemes were later introduced in the successor republics to compensate depositors with public bond schemes, in general compensation has been only partial. Banks did not trust the local currencies either and bank credits became increasingly denominated in foreign currency (mainly euro at present).

In such a situation, lost credibility and deep distrust would have been expected to make any stabilisation effort a long-term endeavour requiring an extended period of policy and institutional reforms to re-establish stability. A remarkable feature of the region is however that macro-economic stability was rapidly restored in the late 1990's or after 2000, with some differences from country to country, the longest delays being recorded by Serbia. While there are a number of explanatory factors for this swift restoration, not least the very positive role played by home macro-economic stabilisation policies supported by IMF programmes and the implementation of a wide range of structural reforms which helped reduce quasi-fiscal deficits, one should not underestimate the role that the DM and later the euro have played across the region as a core stabilising anchor.

In general, the choice of the appropriate exchange rate arrangement of a country is a function of the economic characteristics, main macroeconomic policy objectives, and institutional arrangements. The size and degree of openness of the economy, the flexibility of product and labour markets, the degree of capital mobility and development of financial markets and the need to achieve a sustainable level of macroeconomic stability are usually main factors in this context. Being small and open economies, which were moving towards higher capital mobility and price and wage flexibility, played in favour of adopting fixed exchange rate solutions in the Western Balkans. However, it was mainly the need to curb the very high inflation rates or even hyper-inflation resulting from an inappropriate policy mix or a procrastination of essential structural reforms in many of the economies, combined with lost confidence in local currencies and monetary institutions that tilted the balance towards using the exchange rate as a nominal anchor. The newly established monetary authorities in most cases had little choice but to anchor their national currency to an external one and thereby to recognise their limited room of manoeuvre in directing monetary developments. Moreover, the need to reduce the volatility of the exchange rates represents a crucial aspect of enhancing macroeconomic stability and eliminating uncertainties for trade and capital formation.

Croatia and the former Yugoslav Republic of Macedonia "de facto" pegged their currencies to the euro, although officially their exchange rates are managed floats. In Bosnia and Herzegovina a currency board arrangement was introduced in 1997, with the currency pegged to the Deutsche Mark and, as of 1 January 2002, to the euro. From 2003 to 2005, Serbia opted for a soft peg approach, pursuing a nominal depreciation of the dinar in order to stabilise the real exchange rate. More recently it has moved towards an inflation targeting regime. In all cases, the base money coverage by central bank hard currency reserves has remained above 100%, meaning that even in countries which have avoided corner (hard) peg solutions, the monetary regime still retained some of the main features of a currency board. Initially Albania adopted a managed float approach with the aim of stabilising the exchange rate vis-à-vis a basket of currencies and, more recently, announced its intention to move towards an inflation targeting regime. Montenegro and Kosovo represent special cases with the use of the euro as legal tender.

Under the new monetary regimes, inflation was progressively brought down close to EU levels, except for Serbia where stabilisation started only at end-2000 and inflation has been reduced gradually to a single-digit rate (6.8% at the end of 2007). Pegs were overall remarkably sustainable. Even in the former Yugoslav Republic of Macedonia, in spite of important foreign exchange tensions in the first half of 2001 when civil hostilities erupted in the country, the Central Bank was eventually able to hold the (informal) peg with limited fluctuations and by the end of the year the exchange rate of the denar vis-à-vis the euro had broadly come back to pre-crisis levels. At present Albania and Croatia are faced with domestic currency appreciation pressures owing to large capital inflows and rising productivity.

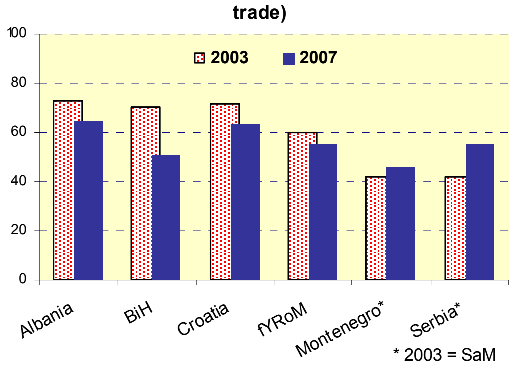
3. THE ROLE OF THE EURO IN THE WESTERN BALKANS AS INTERNATIONAL CURRENCY

The euro is present throughout the Western Balkan countries, either "de jure", through an official, albeit unilateral, introduction of the euro as sole legal tender or "de facto", through its use for savings, borrowing and cash payments, parallel to a domestic currency. The wide use of the euro within the region might be attributable to several reasons, which include geographic proximity to the euro area, economic linkages, migration patterns, the desire to minimize risk, as well as strong historical determinants, as previously mentioned.

3.1. THE EURO AS TRADE INVOICING CURRENCY

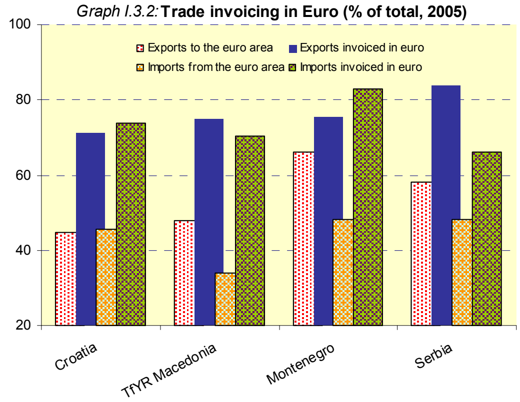
Strong trade links exist between the Western Balkan countries and the EU in general and the euro area in particular. As a result, the use of the euro as an invoicing currency has facilitated the use of the euro in general. Foreign trade of Western Balkan countries with the EU-27, as a percentage of total trade, ranged in 2007 from around 46% in Montenegro to 65% in Albania. Although the share of EU-27 trade has been declining somewhat since 2003, the average level stood at around 55% in the Western Balkan economies.

Graph I.3.1: **Trade with the EU (% of total trade)**



There is only a small difference between the shares of exports and imports with EU-27. However, exports to the EU have a higher share than imports from the EU, also due to the importance of energy in the total import bill, which is usually a trade item outside of the trade relations with the EU-27 and which is playing a more prominent role due to the increase in international prices. The share of exports and imports being invoiced in euro is even higher than what trade shares would suggest. Apparently for a certain amount of trade with non-EU countries the euro is also used as an invoicing currency. For example, in the case of Croatia and the former Yugoslav Republic of Macedonia, for which data are available, the share of both exports and imports invoiced in euro stood at more than 70% of total exports and imports in 2005, gradually increasing from 2001.

Graph I.3.2: **Trade invoicing in Euro (% of total, 2005)**



3.2. THE EURO AS RESERVE CURRENCY

Central banks of the region hold large shares of their foreign currency reserves in euro denominated assets. This is a result of the role of the euro for trade invoicing, its role as a financial currency and the resulting prominent role of the euro exchange rate vis-à-vis the national currencies, as many countries of the region have oriented their monetary and exchange rate policies towards the euro. An extreme case is Bosnia and Herzegovina where foreign exchange reserves denominated in euro account for 99.9% of total reserves in 2006 as the country maintains a currency board against the euro.

The share of euro denominated foreign exchange reserves in total reserves has been rising significantly in all countries of the region since 2002 and reached 86% in Croatia, 82% in the former Yugoslav Republic of Macedonia and 55% in Albania. An additional factor contributing to the growing role of the euro as a

Box I.3.1: **EXCHANGE RATE ARRANGEMENTS AND ANCHORS OF MONETARY POLICY**
(as of January 2008)

External anchor

Euro as legal tender [1]:

- *Montenegro,*
- *Kosovo (UNSCR 1244)*

Currency board arrangement:

- *Bosnia and Herzegovina*

Tightly managed float (de facto peg):

- *Croatia,*
- *The former Yugoslav Republic of Macedonia*

Managed float

- *Serbia* (Inflation targeting framework)

Independent floating

- *Albania* (Inflation targeting framework)

(1) *Reference to EU position on this matter (November 2000 ECOFIN + Council Declaration to SAA with Montenegro).*

reserve currency might be the growing share of euro denominated debt in total foreign debt of Western Balkan countries, reaching 45% for Croatia, 61% for the former Yugoslav Republic of Macedonia and 75% for Serbia in 2006. In addition, the strong inflow of foreign direct investment from the EU into the region during recent years has probably also contributed to the growing role of the euro as a reserve currency.

3.3. THE EURO AS EXCHANGE RATE AND MONETARY ANCHOR

A cursory look at the exchange rate arrangements in the Western Balkans shows that the euro represents a widely used external anchor in the economies (see table above).

Montenegro and Kosovo use the euro as legal tender, as a result of its unilateral introduction in the former and, in the later, UNMIK's decision to use the euro as legal tender. The ECOFIN Council noted that the present use of the euro decided by the Montenegrin authorities in exceptional circumstances is fully distinct from euro area membership and unilateral "euroisation" is not compatible with the Treaty. The current de facto use of the euro in Montenegro does not prejudge EU's position on how to address this issue in possible future accession negotiations. In Bosnia and Herzegovina the domestic currency is pegged to the euro under a currency board arrangement, which has functioned smoothly since 1997. In addition, Croatia and the former Yugoslav Republic of Macedonia have "de facto" pegged their currencies to the euro, although officially their exchange rates are managed floats. The tolerance of the two central banks for exchange rate movements has been relatively low and foreign exchange interventions, open market operations and interest rate adjustments have been used frequently. Consequently, the exchange rates of the kuna and the Macedonian denar (MKD) have remained fairly stable over the past 10 years and have de facto served as a stabilisation device.

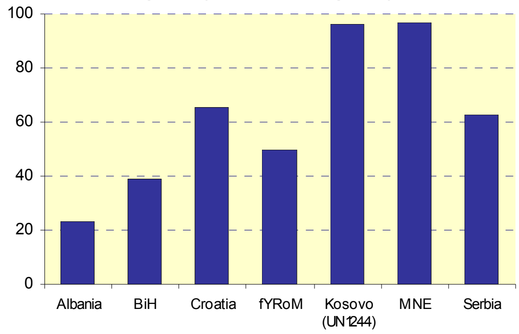
Albania and Serbia are the only countries which have gradually allowed their currencies to float more freely, as they have both announced a move towards an explicit inflation targeting regime. In Albania, the central bank intervenes in the foreign exchange market only occasionally with the objective of smoothing temporary fluctuations and in order to accumulate foreign currency reserves. The National Bank of Serbia continued to intervene in the foreign exchange market in a more systematic way, in order to contain the appreciation of the Serbian denar as a result of strong capital inflows.

As already depicted in the introductory chapter, the use of the Deutsche Mark and subsequently the euro as an external anchor in the economies, together with the adoption of stabilisation programmes, also based on the sound policies promoted under the EMU, was instrumental in swiftly achieving macroeconomic stability after periods of very high or even hyper-inflation. The Western Balkan experience lends support to the traditional view that pegging to a low-inflation country would help promote and maintain fiscal and monetary discipline, rather than to other theories advanced more recently. ([1]) At the same time, the gradual liberalisation of capital movements in the region, together with the build-up of balance sheet risks as a result of the widespread use of the euro as financial currency and unhedged foreign borrowing, reduced the scope for an "independent" monetary policy even more. The concept of the open-economy trilemma emphasized by Obstfeld (1998), i.e. the impossibility for a country to simultaneously have a fixed exchange rate, capital mobility and the monetary policy guided towards domestic objectives, has become an unchallenged part of mainstream economics and explains the inherent difficulties encountered by soft pegs.

3.4. THE EURO AS FINANCIAL CURRENCY

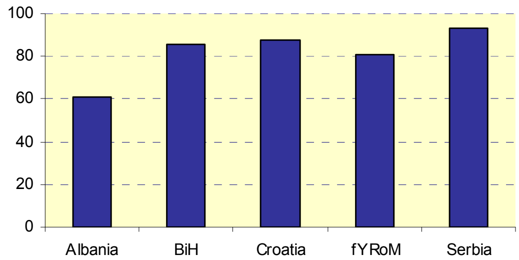
Private households in the Western Balkan countries keep a significant amount of their total deposits and borrow a large proportion of their total credit in foreign currency. In general, over the last few years the use of the euro in domestic financial markets of the Western Balkans has been growing significantly, displacing other foreign currencies. On average about 60% of total deposits and 70% of total loans in these countries were denominated in, or indexed to the euro in 2006. The share of foreign currency loans in total loans is on average higher than the corresponding share of foreign currency deposits. However, the shares of euro denominated or indexed deposits and loans vary widely between countries of the region. For example, in Albania the share in total deposits stood at around 23% in 2006 compared to 63% in Serbia and close to 100% in Kosovo and Montenegro.

Graph I.3.3: **EUR-denominated and EUR-indexed deposits (2006, % total deposits)**



For loans, this number ranged between around 49% in the former Yugoslav Republic of Macedonia and 68% in Serbia. In Montenegro, which has unilaterally introduced the euro, not surprisingly almost 100% of all loans are denominated in euro.

Graph I.3.4: **EUR-denominated and EUR-indexed desposits (2006, % Foreign currency deposits)**



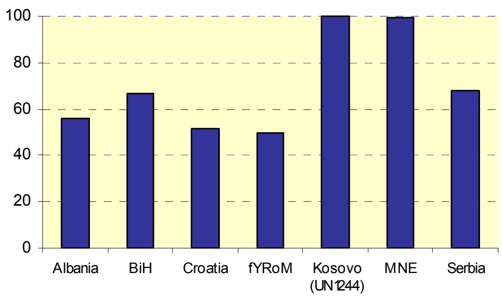
The relatively high share of euro deposits may reflect a lack of confidence in the domestic currency as a store of value. This seems to be particularly prevalent in countries of the former Yugoslavia, in particular in Croatia, Serbia and the former Yugoslav Republic of Macedonia. In particular in these countries, the euro changeover may have contributed to a transitory increase in foreign currency deposits as authorities encouraged households to deposit any legacy

([1]) Tornell and Velasco (2000) claimed that fiscal discipline could not be ensured by pegged arrangements due to a time bias factor, i.e. the eventual outcome – devaluation – is likely to occur not shortly, but at a remote point in time.

currency cash holdings, mostly Deutsche mark and Austrian schilling, formerly kept "under the mattress" in banks, rather than exchange them directly for new euro banknotes. However, since 2002 the share of euro deposits in total deposits has declined gradually in the region, as confidence in the domestic currency gradually recovered. Nevertheless, several studies have identified a hysteresis effect, i.e. a memory of long past banking crises that sharply devalued or wiped out savings, with the foreign currency denominated share of deposits and loans generally changing slowly, often irrespective of the success in restoring monetary stability. Given the difficult legacy of the 1990's in former Yugoslav republics, this may indeed have played a significant role in those countries.

While the share of euro deposits has been declining, the share of euro-denominated and indexed loans has been growing in recent years in several countries. This is partly a reflection of the strong and growing presence of foreign banks, mostly from euro area countries, which have been supporting credit growth in the form of euro denominated lending, also helped by a favourable interest rate differential.

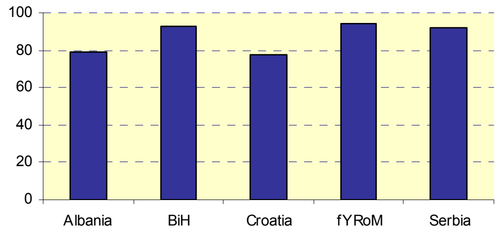
Graph I.3.5: **EUR-denominated and EUR-indexed loans (2006, % total loans)**



Although households account for most of the euro deposits, non-financial corporations represent the lion's share in drawing euro loans. However, in a few countries households borrow significantly in foreign currency as well, either for consumption or mortgages purposes. The presence of foreign-owned banks, offering euro denominated loans at interest rates below those denominated in national currency, probably represents the crucial factor behind the increase in the use of the euro in local loan contracts.

There are several implications related to the substantial use of the euro as a financial currency in parallel to a domestic one. A large share of euro-denominated savings and loans reduce the efficiency of monetary policies using the interest rate channel, since central bank interest rate policies only influence trends in savings and loans denominated in local currency.

Graph I.3.6: **EUR-denominated and EUR-indexed loans (2006, % Foreign currency loans)**



For lasting macroeconomic stability to be achieved, monetary policy must operate primarily through other channels or receive greater support from other policy areas. In addition, the widespread use of euro-denominated instruments, particularly for borrowing, is a potential source of financial instability for the countries affected. This is especially true when borrowers have no euro income or no way of hedging their currency exposure. While financial institutions are usually required to limit their foreign currency mismatches or hedge them, their clients and especially the households are not subject to similar strict rules. As a result, a depreciating exchange rate may restore some of the country's external competitiveness, but at the same time puts borrowers at risk. They can face solvency problems, which in turn represent an indirect credit risk for the banks that granted these loans.

Essentially, the widespread use of the euro as a financial currency in the Western Balkans is, in most parts, a reflection of the process of financial integration between the region and the euro area.

3.5. THE EURO AS PARALLEL CASH

It is difficult to obtain hard data on euro cash holdings outside the euro area. Surveys and econometric models can be methodologically used for this purpose. For example cash holdings can be estimated using models that are applied to national accounts and monetary data (Feige, 2003). The results obtained by Feige point to relatively high currency substitution rates in several transition economies. Substitution rates range from about 20% to above 50%. Another approach involves direct questioning households and then projecting the extent of currency substitution from the survey results. This approach has been used by the Austrian National Banks (OeNB) since 1997. At the start of the OeNB survey series, a sizeable share of the respondents held cash in foreign currency, primarily Deutsche mark, Austrian schilling and U.S. dollar. When the euro was introduced, Deutsche mark and Austrian schilling holdings were to a large extent exchanged for euro or domestic currency, but rarely for U.S. dollar. According to the OeNB survey, households in countries of the former Yugoslavia have the highest volumes of cash holdings among European transition economies. This can be explained by the fact that the euro tends to fulfil a general reserve function or to be used for domestic transactions, in former Yugoslavia countries, whereas euro cash holdings in the other countries are used mainly for spending and vacations abroad. Survey data also indicates that the share of households with euro cash holdings is higher for those with relatives in euro area countries than for those with no family ties abroad, suggesting that such holdings may stem, at least partially, from remittances from family members abroad. In addition, an upward trend in euro cash holdings in the Western Balkans since 2002 was detected, with the proportion of respondents holding euros having reached 25% in Croatia at the end of 2006, well above the proportion of respondents holding dollars.

4. IMPROVED ECONOMIC STABILITY AND PERFORMANCE IN THE WESTERN BALKANS

In the aftermath of the crises in the nineties, the Western Balkans were faced with strong and urgent challenges of economic adjustment and stabilisation. The introduction of new monetary regimes based on the DM and later the euro helped curb previously rampant inflation to almost EU levels. Both the official use of the euro – as exchange rate anchor and reserve currency – and the unofficial use by the private sector – as parallel cash or financial currency were key in avoiding an economic collapse in the first stages of the Yugoslav crises and subsequently helped remonetise the economies, rebuild domestic savings and promote deeper financial and trade integration with the EU. At the same time, the wide-spread use of the DM/euro as financial currency or parallel cash complicated the mechanisms of monetary transmission at a later stage and facilitated the accumulation of balance-sheet risks. Nonetheless, the overall result has been improved macroeconomic stability and fairly robust economic growth, despite the challenges that are inherent to a rapid catching-up process.

In addition, the EU membership prospects have increased the Western Balkans' attention to the European Monetary Union's objectives, standards and economic surveillance instruments. The candidate and potential candidate countries from the Western Balkans are becoming increasingly aware of the need for a rapid real convergence towards EU Member States' income levels, while targeting in parallel a medium-term nominal convergence towards EU standards, in particular those highlighted by the Maastricht criteria. The successful candidates need to fulfil, among other, the Copenhagen economic criteria, which require the existence of a functioning market economy and the capacity to cope with competitive pressure and market forces in the EU. For that purpose, candidate and potential candidate countries from the Western Balkans are pursuing a wide-range of reforms in order to achieve macroeconomic stability, liberalise markets, restructure and privatise the state-owned industries, improve their business environment and build human and physical capital. These reforms are key for preserving stability in the face of growing external imbalances and rapid financial deepening. Being part of the accession process, where progress in economic, social and political areas is closely monitored by the European Commission, represents an additional guarantee to investors and international capital markets that the Western Balkan economies are pursuing sound public policies. This further reinforces credibility and financial stability in the region.

As accession draws nearer, the candidate and potential candidate countries from the Western Balkans are gradually being integrated in the multilateral surveillance and economic policy co-ordination procedures of the European Monetary Union[1]. In this context, the European Commission has established jointly with the candidate and potential candidate countries a pre-accession fiscal surveillance procedure. This surveillance framework includes various components, depending on the individual status in the accession process, with the candidate countries following more closely, but in a simplified manner, the permanent fiscal surveillance procedures for Member States. The candidate countries prepare Pre-accession Economic Programmes and Fiscal notifications, participate in bilateral and multilateral economic dialogues and may benefit from macro-financial assistance. The potential candidate countries prepare Economic and Fiscal Programmes, participate in bilateral economic dialogues and some benefited from macro-financial assistance as well. Together with the programmes and frameworks used by other international institutions, such as the IMF, the fiscal surveillance framework put in place by the European Commission plays an important role in fostering macro-economic stability and catching-up in the Western Balkans.

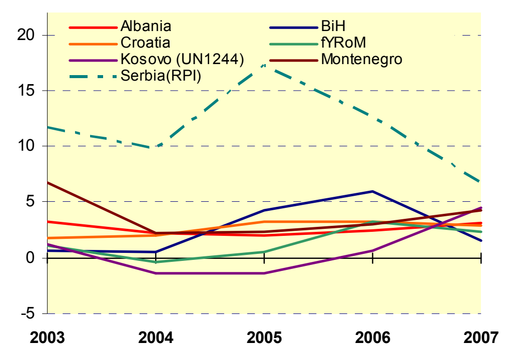
4.1. RAPID DISINFLATION TO EURO AREA LEVELS

Irrespective of the systemic settings, the policy mix in the Western Balkan economies has

[1] For more details, please see the second paper in the publication.

become gradually much more transparent and consistent, which helped them gain stability and credibility. In contrast to the episodes of very high and even hyperinflation in the early 1990's, inflation came down significantly in almost all Western Balkan economies. Sizeable differences between the individual economies are due to country specific features, including exchange rate regimes and the tightness of the monetary and fiscal policy mix.

Graph I.4.1: **Inflation (Annual average % change)**



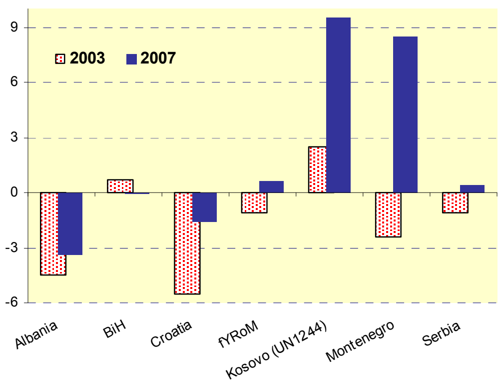
As stabilisation took hold in the Western Balkan countries, annual inflation was fairly quickly and substantially reduced to moderate rates until 2006, in all the economies but Serbia. The fall in inflation rates was rather steady in the region, except for some temporary flare-ups in Bosnia and Herzegovina and the former Yugoslav Republic of Macedonia. In the former, the introduction of VAT and increases in administered prices led to a temporary surge in inflation in 2006, which however receded significantly in 2007. In the latter, the impact of increases in excise duties in 2006 was phased out in the first half of 2007.

Nonetheless, the re-emergence of inflationary pressures led by food and oil prices on a global scale in the second half of 2007 affected also the Western Balkans. In the first quarter of 2008, inflation accelerated to above 11% year-on-year in Serbia, Kosovo and 9.5% in the former Yugoslav Republic of Macedonia and rose above 6% in Bosnia and Herzegovina and 8% in Montenegro. In Albania and Croatia, although an increase in inflation also took place, it remained moderate. The inflation rise above increases recorded in the EU, despite the euro pegs, reflects primarily the higher share of food and energy prices in the local CPI baskets. In addition, other factors are at work, such as the Balassa-Samuelson effect and the much higher growth rates of domestic demand fuelled by the large capital inflows and the rapid growth of credit. In some economies, the liberalisation of administered prices will still play an important role in terms of nominal price convergence with the euro area in the following years.

4.2. CONSOLIDATED FISCAL STANCE

Given the narrow margin for autonomous monetary policies, the onus throughout the region has been mostly on fiscal policies to provide the core macroeconomic policy stance. This was all the more necessary given: (i) sizeable general government deficits at the turn of the century; (ii) heavy governments and public sectors, requiring some downsizing of public expenditure, in Croatia, Serbia, and Bosnia and Herzegovina; and (iii) sizeable current account deficits with the ensuing need to curb down internal demand growth.

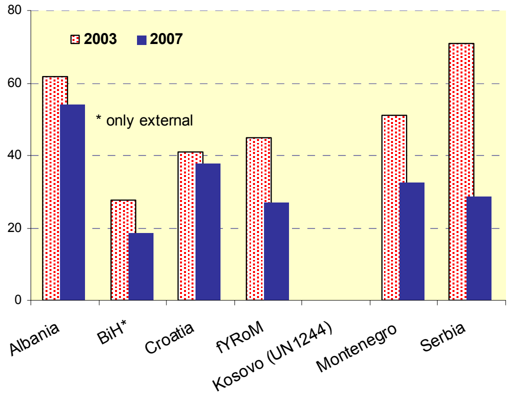
Graph I.4.2: **General Government Balance (% of GDP)**



Over the recent years, domestic policies, supported by IMF programmes, have overall been tightened and provided for a fiscal consolidation. A sizeable adjustment took place in Albania, Bosnia and Herzegovina, and the former Yugoslav Republic of Macedonia, but more recently also in Kosovo, Montenegro and Croatia. Kosovo remains a special case with a high volatility of budget outcomes and, at times, unintentional fiscal tightening given the difference between planned and executed budgets.

However, the pattern of fiscal consolidation has been quite different among countries. Overall in the region, from 2000 to 2007 fiscal consolidation was mainly achieved through a mix of expenditure reduction as a share of GDP and revenue increases in candidate countries, whereas potential candidate countries mainly relied on growing revenues boosted by buoyant tax collection.

Graph I.4.3: **Public Debt (% of GDP)**

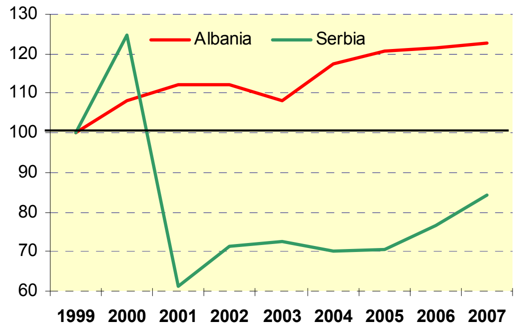


This fiscal consolidation enabled a reduction in public debt down to more sustainable levels throughout the region. In Serbia and Montenegro, favourable agreements reached with the Paris Club (66% debt reduction) and the London club further allowed for a spectacular reduction of public sovereign debt. Yet, some countries are still facing significant contingent liabilities, in particular Bosnia and Herzegovina, where war related claims on the governments and other domestic liabilities could substantially add to official debt figures and call for prudent fiscal policies. Kosovo under the UN administration has not serviced any international claims, nor issued any public borrowing, but it may inherit, at some stage, a share of sovereign liabilities currently serviced by Serbia.

4.3. TRENDS IN THE REAL EXCHANGE RATE AND EXPORT PERFORMANCE

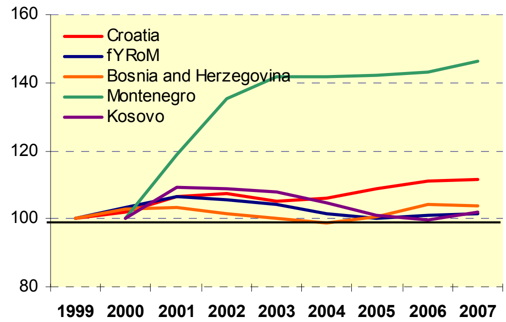
In recent years, the currencies of the Western Balkan economies showed, in terms of CPI, a trend of real appreciation vis-à-vis the euro, which is much less pronounced when unit labour costs are used as a basis for comparison. Montenegro and Albania recorded a substantial real appreciation of the exchange rate against the euro between 1999 and 2007, mainly due to higher inflation rates than in the euro area.

Graph I.4.4: **Real Exchange Rate vs. the EUR**
(CPI-based)



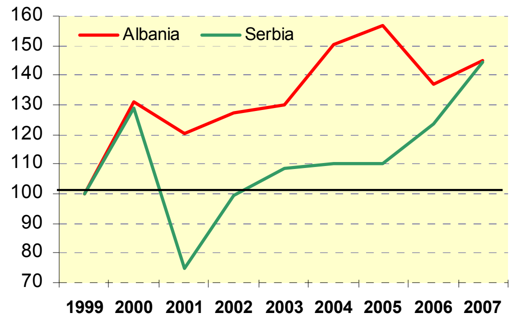
In Montenegro, the real exchange rate appreciation was the largest at about 45%, whereas the Serbian Denar depreciated strongly mainly as a result of the exchange rate crisis of 1999-2001 when the exchange rate collapsed following the war in Kosovo.

Graph I.4.5: **Real Exchange Rate vs. the EUR**
(CPI-based)



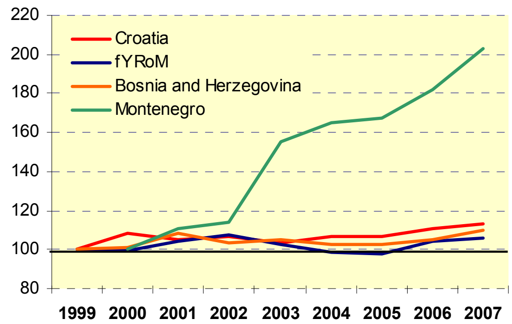
Nonetheless, significant gains in terms of labour productivity offset wage increases and the evolution of the real exchange rates in terms of ULC is generally more favourable than in terms of CPI. In Croatia, Bosnia and Herzegovina and the former Yugoslav Republic of Macedonia the real exchange rate appreciation in terms of ULC was below or around 10% in the analysed period, showing a relatively sound interconnection between the evolution of labour productivity, wages and the exchange rate.

Graph I.4.6: **Real Exchange Rate vs. the EUR**
(ULC-based)



Only in Montenegro, Albania and Serbia, real exchange rates (based on ULC) have appreciated against the euro by large amounts – around 100% in the first economy and 45% in the last two – mainly due to a hefty growth of labour costs.

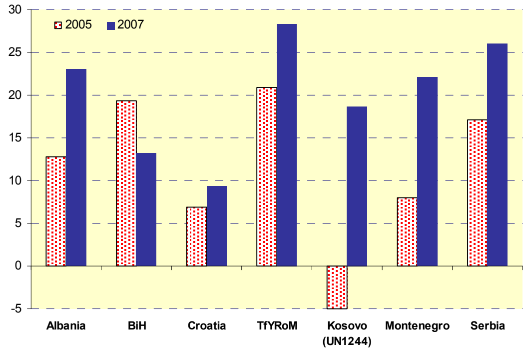
Graph I.4.7: **Real Exchange Rate vs. the EUR**
(ULC-based)



The external competitiveness of these economies was affected, but the magnitude of the impact can only be assessed indirectly, as the real exchange rate analysis encompasses only trends and not levels. By looking at complementary indicators it appears that the Serbian and Albanian economies have maintained competitiveness by gradually shifting production and exports into higher value-added sectors, whereas the Montenegrin one is developing a competitive tourism industry while its export capacity remains limited, mainly consisting of low-processed goods.

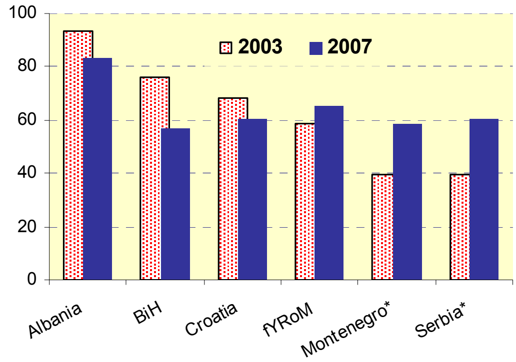
There was a general upward trend in the growth rate of exports of goods and services from 2005 to 2007 in all the economies, except for Bosnia and Herzegovina. Over the period, the growth of exports was fairly robust, with a double digit average growth rate being recorded in all economies, except for Croatia and Kosovo. Exports grew on average by around 9% in Croatia and were declining in Kosovo until 2006, when the trend reversed and the Kosovan exports of goods and services grew by a double-digit rate, although from still very low levels.

Graph I.4.8: **Exports of goods and services**
(annual % change, 2005-2007)



The evolution of exports demonstrates the gradual improvement of the export capacity of the economies. However, exports to the European Union grew slower than to the world on average, with the exceptions of the former Yugoslav Republic of Macedonia, Montenegro and Serbia, showing that other factors, such as geographical proximity, previous strong regional trade links and new regional trade agreements or structure of exports also play an important role in this process rather than only pegged exchange rates.

Graph I.4.9: **Exports to EU**
(% of Total exports)



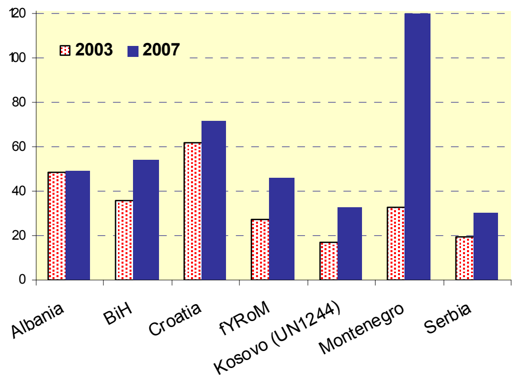
4.4. REDUCTION OF TRANSACTION COSTS AND UNCERTAINTY

The large economic base of the euro and the elimination of the transaction costs involved with multiple exchange rates have increased gradually the use of the euro as a unit of account in the denomination of foreign trade flows in the Western Balkans (see sub-chapter 3.1). The euro facilitated trade between the Western Balkans and the EU by eliminating exchange rate uncertainty, allowing companies to compare costs and save money on foreign exchange hedging. In this respect, the benefits are usually more pronounced for small and medium-sized enterprises. Benefits are – to some extent – visible in export statistics where the exports from the Western Balkans to the euro area and the EU in general have been on an increasing trend in recent years. However, it seems that other factors such as further integration of regional trade and the relatively slow improvement of the structure and quality of exports did not allow the Western Balkan economies to fully tap into the growth of the EU markets in 2006 and 2007. The signing of Stabilisation and Association Agreements with all the countries in the region should give another boost to the process of trade integration between the EU and the Western Balkans.

4.5. REMONETISATION OF ECONOMIES AND REBUILDING OF DOMESTIC SAVINGS

As in the new Member States, remonetisation is a key element in the overall transition process of the Western Balkan economies. In tandem with the disinflation process, which increased confidence in the domestic currencies, the money stock in Western Balkan countries started to rise. The levels of base money (M0) vary greatly amongst the Western Balkan countries. Relative to GDP, the levels are around the highest in Albania, Bosnia and Herzegovina and Montenegro. Since 2000, the fastest growth was observed in Bosnia and Herzegovina, Croatia and the former Yugoslav Republic of Macedonia. It is part of financial sector transformation at large. This process has also contributed to the fairly strong output growth in recent years that was mainly driven by domestic demand (both private consumption and fixed capital formation) and accompanied by external imbalances in most countries.

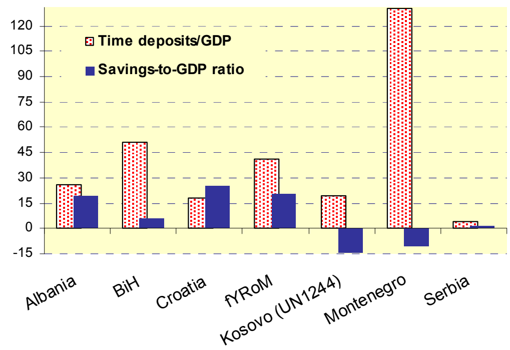
Graph I.4.10: **Broad Money (% of GDP)**



The broad money aggregates have also increased strongly in most economies, and as such, it may reflect increased confidence in the banking sector. The highest growth rates were recorded in the former Yugoslav Republic of Macedonia, Kosovo and in particular in Montenegro. In the latter, the very large inflows of foreign capital relative to GDP, both as foreign direct investment and lending, contributed to a massive increase in the money supply from around 30% in 2003 to almost 120% in 2007. The money multiplier (relationship between narrow and broad money) is fairly low in Albania and Bosnia and Herzegovina in comparison with the other countries in the region, most likely as a result of lower cross-border financial integration in the former and as a consequence of the currency board constraints in the latter.

Western Balkan economies are, like most typical transition economies, characterized by saving ratios which are in the low to medium range. The economic transformation of the former centrally planned economies is evidenced by a fundamental reallocation of resources and deep economic structural change. Within this process, also the amount of domestic savings has increased, primarily mirrored by the gradual increase in the ratio of time deposits as a share of GDP. On the other hand, the savings-to-GDP ratio as captured by the national accounts statistics is still low or even negative in economies like Bosnia and Herzegovina, Kosovo, Montenegro and Serbia, mainly reflecting the large share of domestic consumption financed to a large extent by foreign resources.

Graph I.4.11: **Domestic savings (% of GDP)**

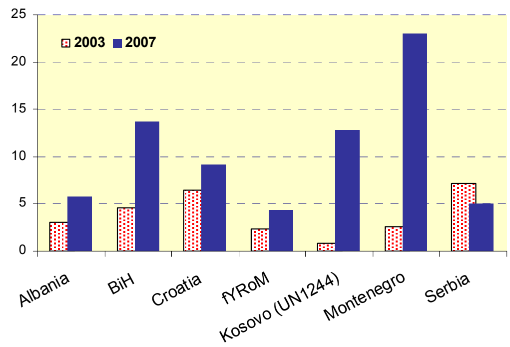


The only countries which have normalised their saving behaviour as revealed by the national accounts appear to be Albania, Croatia and the former Yugoslav Republic of Macedonia.

4.6. HIGHER FINANCIAL INTEGRATION AND INFLOW OF FOREIGN SAVINGS

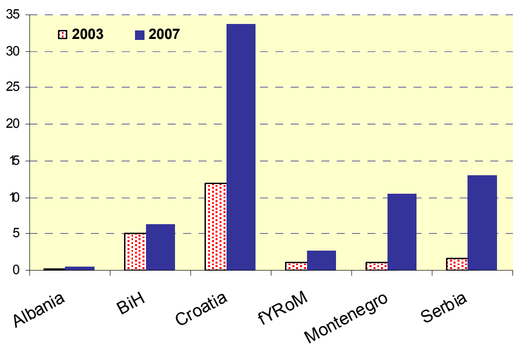
Despite their increase, domestic savings are still not sufficient to cover the significant investment needs in the Western Balkans. Access of the economies to the international financial markets appears to have been facilitated by the expansion of global liquidity in recent years. The most advanced Western Balkan economies (in particular Croatia) have clearly benefited from this process and have been able to attract significant foreign capital, including FDI. The bulk of these inflows originated from the euro area. It remains to be seen how the inflow of net FDI, which has increased strongly in the region so far, would be affected by the recent international credit crunch and the prospects of a global economic slowdown.

Graph I.4.12: **Foreign Direct Investment (net, % of GDP)**



The creation of a wider, deeper, and more liquid financial market in the euro area reduced transaction and borrowing costs also for borrowers from the Western Balkans. In Croatia, the non-bank private sector is financing its needs increasingly abroad and in euro. Also in other economies, such as Bosnia and Herzegovina, Montenegro and Serbia, the level of cross-border lending to the domestic private sector has increased to more meaningful levels. Albania and the former Yugoslav Republic of Macedonia are trailing the group in this respect. The whole process needs to be seen in the context of improved economic performance and eligibility for foreign financing of domestic companies following the privatisation and restructuring process. Sometimes, the measures taken by central banks to curb the growth of domestic credit have also played an important role in stimulating cross-border lending.

Graph I.4.13: **Cross-border lending (non-banks, % of GDP)**

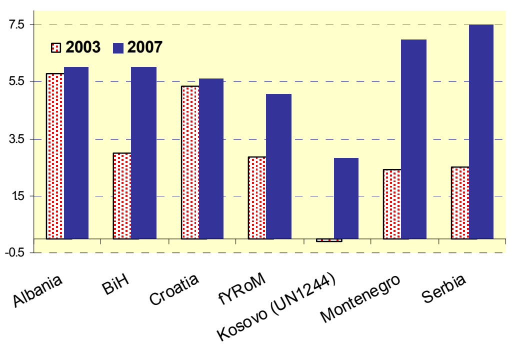


Not only the private sector, but also the public one has found its way to tap the euro denominated sovereign bonds market. Croatia was particularly successful issuing EUR 2.25 billion worth of Eurobonds since 2001.

4.7. ROBUST ECONOMIC GROWTH

Economic growth in the Western Balkan countries compares favourably to the one in mature economies.

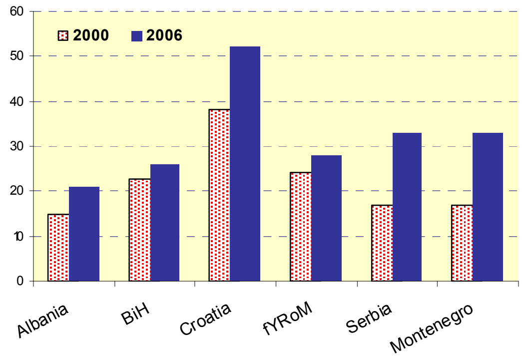
Graph I.4.14: **Real GDP growth (annual % change)**



After initial output losses as a result of the violent conflicts of the region and initial transition steps, the economies started to quickly stabilise, and the average growth rate inched up from about 3% in 2003 to close to 6% in 2007.

Growth in the region is particularly supported by the EU accession perspective which promotes sound economic policies and increased amounts of FDI, thus contributing decisively to the modernisation of productive capacities in the region.

Graph I.4.15: **GDP in PPP (% of EU average)**



However, the growth potential in the region remains lower than in the Baltics or other New Member States, which have been growing faster in recent years. In particular, if the lower starting point in terms of GDP per capita in PPP (as a share of the EU average) is taken into account (except for Croatia), the Western Balkans appear as a region which still needs to unleash its growth potential.

5. FUTURE CHALLENGES

As described in previous sections, the use of the DM and later the euro – be it as an anchor currency or via de jure or de facto euroisation - has helped promote economic stabilisation in the countries concerned. For small open economies such as the Western Balkan economies, in particular with their history of rampant inflation and continuous depreciations, using an "independent" monetary and exchange rate policy as a tool for inflation management or external competitiveness purposes is indeed not likely to be a realistic option. Devaluating the domestic currency cannot represent a universal panacea and an adequate substitute for the necessary market adjustment of relative prices. In addition, the alleged blessings of devaluation can only be temporary and once domestic prices and wages adjust to the new equilibrium, the previous "competitive" advantage is cancelled.

But just like in the case of the euro area, exchange rate stability in itself will not promote stability and durable growth. In addition to sound fiscal policies, appropriate wage and price policies need to be in place, together with, well-functioning goods and labour markets to allow for an efficient adjustment of relative prices. For this reason, the remainder of the chapter takes stock of the adequate functioning of markets in the Western Balkans and tries to assess whether external competitiveness came under pressure in the context of rapid economic catching-up and financial deepening.

5.1. ADEQUATE FUNCTIONING OF MARKETS IS KEY

Several Western Balkan economies, including Croatia, the former Yugoslav Republic of Macedonia, Albania and Montenegro are relatively advanced with respect to increasing private ownership and aligning legislation with the EU acquis. Others like Bosnia and Herzegovina, Kosovo or Serbia are less so. Nonetheless, the remaining challenges in ensuring an adequate functioning of markets are significant in all of them. In most countries, labour markets are not flexible enough, while wages in the registered economy are subject to a relatively high taxation of labour and distorted wage setting mechanisms. Under these circumstances, competitiveness is most likely facilitated by the considerable informal sector. However, the "flexibility" provided by the informal sector comes at the cost of inadequate social protection for the unofficial employees and foregone revenues to the budgets.

The liberalisation of network industries is still on-going as well as the restructuring of state-owned enterprises, with mixed results across the board. The weak capacities of the public sector and the judiciary impede swift structural change and an adequate protection of ownership rights. Furthermore, applying the necessary supervisory and prudential standards in the financial sector seems to be still challenging for the domestic institutions in charge, although the situation is gradually improving.

Private ownership of companies is generally regarded as more efficient and better able to react to changing market conditions than state ownership. In the Western Balkans, the transition to market economy started later than in Central and Eastern Europe and on average took longer to achieve a critical mass of privatised companies in the economy. At present, the private sector's share of output has reached a relatively high level, particularly in Croatia, the former Yugoslav Republic of Macedonia, Albania and Montenegro. However, even in the more advanced economies, sectors remain where privatisation and restructuring have progressed only slowly, such as the shipbuilding sector in Croatia, the oil sector in Albania or the railway sector in general. The liberalisation of network industries is deeper in telecommunications, but less so in the energy and utilities sectors. The weight of the private sector is clearly insufficient in Serbia and Bosnia and Herzegovina (in particular in the Federation of Bosnia and Herzegovina) and to a smaller extent in Kosovo. As a result, quasi fiscal deficits remain significant in the sector of state-owned enterprises, as well as the budget subsidies which represent the life-line of unviable companies.

Most of the countries of the region, have made substantial efforts and progress in improving the entry and exit procedures of their economy. ([1]) With respect to the duration and the costs of enterprise registration, the former Yugoslav Republic of Macedonia is the most advanced country in the region, while most others have made important progress in recent years. Only Bosnia and Herzegovina appears to be a clear laggard in the group. In terms of time and cost required to solve bankruptcies, the best positioned country is Montenegro, while the former Yugoslav Republic of Macedonia and Albania are trailing the group.

Registration of property rights and enforcement of contracts are two areas where the Western Balkans score fairly low in comparison with the OECD countries. This impacts negatively their capacity to foster domestic and foreign investment, diminishing the adjustment potential of the economies. Only Croatia, Albania and to a certain extent the former Yugoslav Republic of Macedonia have made more progress on average in these areas.

Overall the capacity of the Western Balkan economies to react swiftly to domestic or external shocks is hampered by an insufficient degree of market flexibility, although significant progress was made in recent years. In particular the labour markets suffer from structural rigidities, whereas all the economies lag behind the OECD countries and progress has been fairly slow. The liberalisation of markets for goods has been more dynamic as well as the improvements in the business environment in general. The former Yugoslav Republic of Macedonia and Montenegro seem to be more advanced in the process, while in particular Bosnia and Herzegovina and to some extent Albania need to accelerate the pace of reforms.

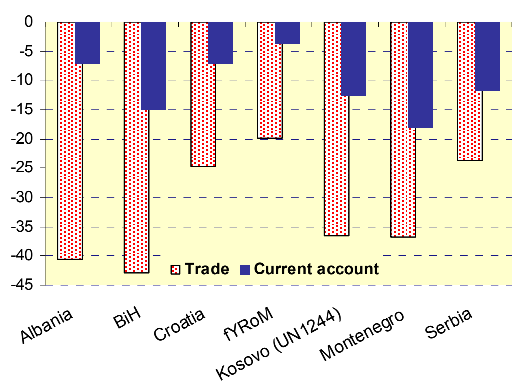
([1]) See also the World Bank's Doing Business 2009 at www.doingbusiness.org

5.2. CATCHING-UP PROCESS ACCOMPANIED BY LARGE EXTERNAL IMBALANCES AND RAPID FINANCIAL DEEPENING

5.2.1. External imbalances

Trade and current account deficits were quite high in the economies in the past years. On average, between 2003 and 2007, all economies recorded a trade deficit above 20% of GDP, in some cases being as high as 40% of GDP. In general, the current account deficits were much lower, due to positive balances in services – in particular in tourism, ample worker remittances and official transfers which were significant mainly for Kosovo and Bosnia and Herzegovina. Nevertheless, the size of the current account deficits was significant in all the economies, with the exception of the former Yugoslav Republic of Macedonia. On average, it exceeded double-digit levels in Bosnia and Herzegovina, Kosovo, Montenegro and Serbia during 2003 – 2007.

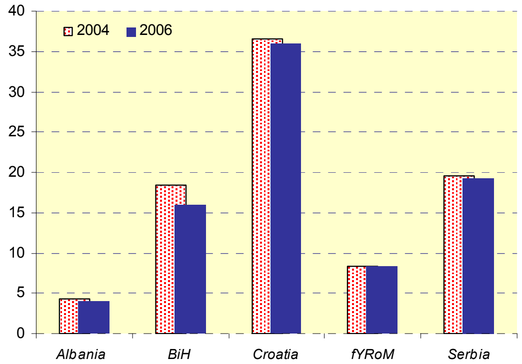
Graph I.5.1: **External Balances (% of GDP, 2007)**



The sizeable external imbalances are closely linked to the countries' status of catching-up economies and the robust inflows of foreign capital. These imbalances may not be necessarily triggered by a loss of external competitiveness, especially as the performance of exports was favourable. With the exception of Kosovo which only recorded a positive growth rate of exports in 2006 and 2007, in the other economies the exports of goods and services grew at a healthy pace during the past five years. This is mainly the result of the restructuring of domestic productive capacities with the help of foreign direct investment and the favourable evolution of international prices for certain commodities and in particular for base metals.

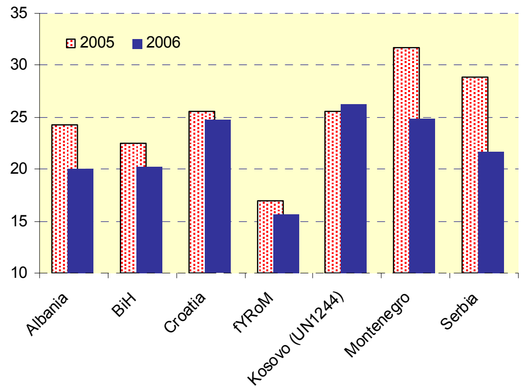
In addition, as described in the previous section, the evolution of the real exchange rate in terms of unit labour costs between 2000 and 2007 suggests that external competitiveness was to a large extent preserved in most of the Western Balkan economies, but less so in Montenegro, Albania and Serbia. External competitiveness may come under additional strain in light of the recent increases in energy prices, given the high energy intensity of these economies. The composition of exports remains skewed in favour of lower value-added goods. The share of capital and technology intensive goods in total exports increased only modestly in recent years, and except for Croatia and to a certain extent Serbia and Bosnia and Herzegovina, the overall level remains quite low.

Graph I.5.2: **Export of Capital and Technology Intensive Goods (SITC cat. 7, 5.4, 6.2.5, 8.7 and 8.8, % of total exports)**



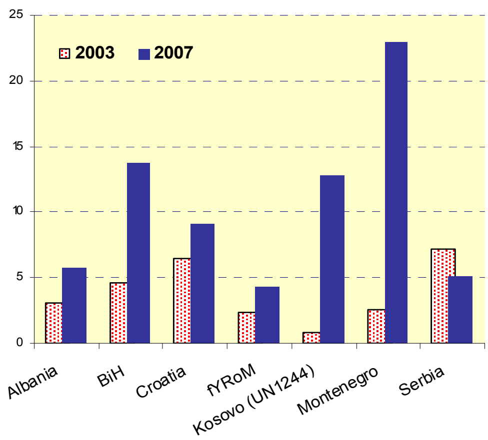
On the other hand, the sustainability of the deficits depends crucially on the composition of imports and their financing structure, i.e. the share of foreign direct investment and other non-debt creating financial flows, which ideally should support the creation of a robust productive basis. Imports of capital goods play a different role in the countries' imports and in most cases their share declined recently, as a result of strong dynamics in household consumption. Nonetheless, the current levels hint at an import structure which is relatively favourable to the increase of the production potential of the economies over the medium term. Country-specific differences are not so large with the exception of the former Yugoslav Republic of Macedonia which exhibits a relatively lower import content of investment goods.

Graph I.5.3: **Import of investment goods (SITC cat. 7, without 7.8, % of total EU imports)**



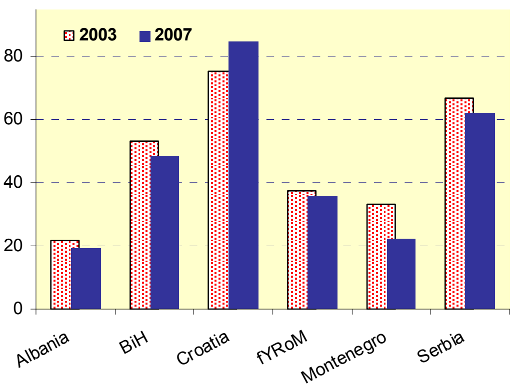
FDI inflows have been on the rise in the Western Balkans between 2003 and 2007, mainly as a result of an improving business environment, accelerated privatisation and ample global liquidity coupled with a buoyant investor sentiment. In all economies except for Albania and the former Yugoslav Republic of Macedonia net FDI exceeded on average 5% of GDP between 2003 and 2007. About half of the very high levels of FDI recorded in Montenegro in 2005 - 2007 went into real estate activities. The coverage of current account deficits with net FDI over the period was fairly good in Montenegro, the former Yugoslav Republic of Macedonia, Croatia and Serbia.

Graph I.5.4: **Net FDI (% of GDP)**



External indebtedness relative to GDP has been on a declining trend in the region from 2003 to 2007, despite the sizeable external deficits that were recorded. The good coverage of deficits with non-debt creating financial inflows, diminishing public external debt and robust GDP growth facilitated this trend. Only in Croatia external debt-to-GDP increased over the period despite its already high level. Croatia stands out in the group as the country with the largest external burden. Nonetheless, the sizeable foreign assets of the banking system imply that Croatia's "net" external debt is significantly lower than suggested above. Moreover, most of the economies display a rather comfortable level of official foreign exchange reserves, exceeding four months of imports of goods and services. In Montenegro and Kosovo, the cushion provided by official reserves is relatively lower than in the other economies, mainly because of their special monetary arrangements. Due to the unilateral use of the euro, the Montenegrin and Kosovan monetary authority do not need to back a domestic currency by foreign official reserves.

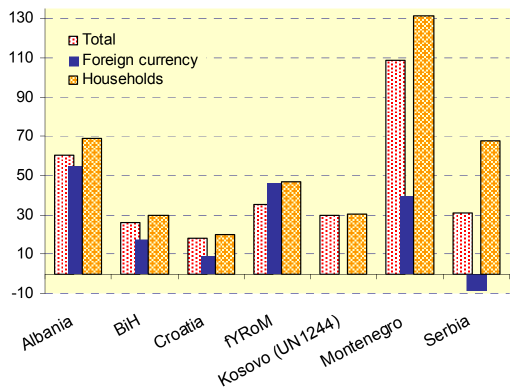
Graph I.5.5: **External Debt (% of GDP)**



5.2.2. A process of rapid financial deepening

Albeit starting from low levels, credit growth is high or relatively high in the region and has maintained this trend even after the financial turmoil started to affect the international capital markets in late-2007. In recent years, banks have been increasingly expanding their asset portfolio into more risky investments and competition for market shares sharpened in the region which could result in a deterioration of the quality of loan portfolios. In addition, the large degree of lending in foreign currency makes systems vulnerable to excessive exchange rate volatility. Even though, in general, banks are well hedged against the foreign exchange risk and their net open positions in foreign currency are limited, their clients, which are increasingly households, are often less hedged. Some of the economies experienced banking crises in the recent past, increasing the depositors' apprehension. Also, not long ago state directed and connected lending still represented commonplace practices in many of the banking systems in the region.

Graph I.5.6: **Domestic credit (avg. annual growth 2005-2007)**



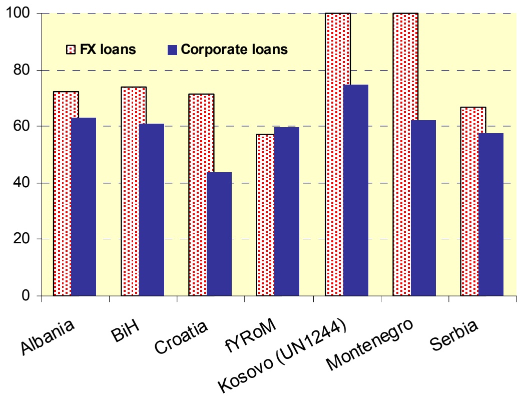
One of the factors mitigating these risks is the large degree of bank privatisation that took place in the region, especially when international reputable banks became the new owners. In addition, the regulatory and supervisory capacities of the authorities were significantly strengthened in most of the economies, but there are still some concerns about the independence of supervisors and the degree of implementation of the new and improved regulations. In 2008, some countries like Montenegro, Serbia and Bosnia and Herzegovina took monetary policy or administrative measures to reduce the speed of credit growth, but their success can only be traced in Montenegro so far, where the average monthly growth rate of domestic credit declined from about 10% in 2007 to 3% in the first quarter of 2008. The more restrictive lending conditions on the international capital markets did not appear to have a visible impact in the region so far and even assuming it had one - within reasonable limits, it would actually provide some support to the authorities which strive for a slowdown of domestic credit growth.

Domestic credit has been growing relatively fast in the entire region. In the past three years, Montenegro, Albania, the former Yugoslav Republic of Macedonia, Kosovo and Serbia, posted very high annualised credit growth rates which exceeded 30% on average. The other economies, Bosnia and Herzegovina and Croatia, experienced a more moderate dynamic of credit but still at double digit annualised rates. Credit growth is driven by the private sector component in most of the economies and in particular by household lending. In 2007, household credit grew by close to 155% in Montenegro and 60% in Albania. Lending in foreign currency or indexed to foreign currency is widespread in the economies and also grew very fast on average in Albania, the former Yugoslav Republic of Macedonia and Montenegro between 2005 and 2007.

In some of the economies such as Bosnia and Herzegovina, Montenegro, Serbia, and in particular Croatia, an increased amount of cross-border lending flows directly into the non-bank sector. This adds to the already high levels of domestic foreign currency lending in the region, which exceeded two thirds of total domestic credit in Albania, Bosnia and Herzegovina, Croatia and Serbia in 2007. In certain cases, the more dynamic cross-border lending represented a response to internal restrictions, including high reserve requirements or credit ceilings imposed by central banks, aimed at reducing domestic credit growth or redirecting it into domestic currency. As a result, now the balance sheets of domestic credit institutions reflect only partially the outstanding foreign currency assets and the risks assumed in the economy. As mentioned before, this large and increasing component of lending in foreign currency complicates policy-making and adds to macroeconomic risks.

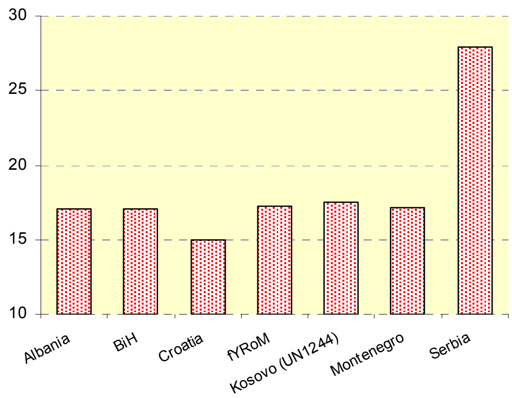
The corporate sector is still predominant in the allocation of credit, but the dynamics are skewed in favour of the households. The 2007 data shows that the allocation of credit between household and enterprise sectors is still conducive to economic growth in most of the Western Balkans, with the enterprise sector claiming close to or more than 60% of total private credit in all the economies, except for Croatia where it was slightly above 40% at the end of 2007. As an increasing share of lending is allocated to non-productive activities such as household consumption or real estate, financial sector stability comes under pressure, requiring an adequate regulation and supervision.

Graph I.5.7: **Structure of lending (% of total lending, 2007)**



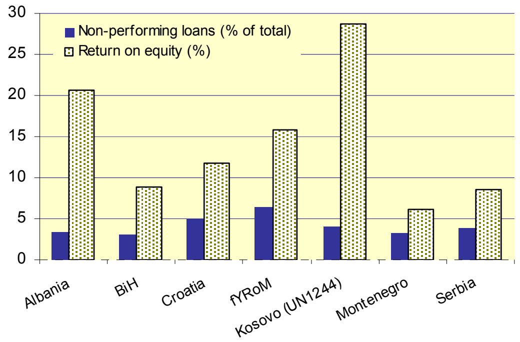
The prudential indicators of the banking systems showed positive developments. The average capital adequacy ratio stood at around 18% in the region at the end of 2007, well above the 12% threshold. However, ratios are coming down relatively fast due to the banks' rising lending activities. Croatia shows the lowest capital adequacy ratio at the end of 2007, but the level is not yet a reason for concern and it increased from 2006 as the banks put aside additional capital reserves, following the stricter risk-weighted regulations issued by the central bank.

Graph I.5.8: **Capital Adequacy Ratio (end 2007)**



Differences in the ratios of non-performing loans to total loans are more substantial. The ratio appears to be declining in most economies in 2007, except for Albania. This is to a large extent the result of the strong increase in the stock of loans, which may point to higher risks in the future. Currently, the level is relatively high only in the former Yugoslav Republic of Macedonia. The average profitability of the banking systems measured by the return-on-equity ratio increased in general from 2003 to 2007 and reached comfortable levels in all economies.

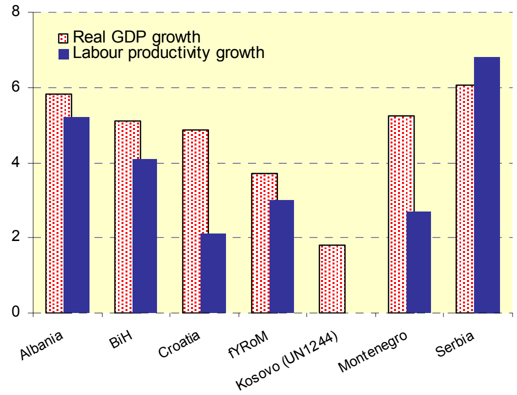
Graph I.5.9: **Bank Prudential Indicators (end 2007)**



5.2.3. Economic growth and its drivers

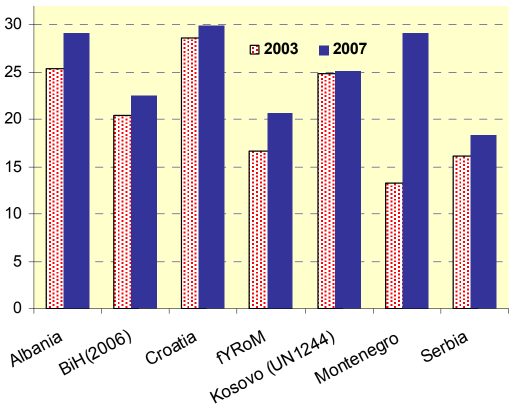
The economies recorded moderate to strong growth over 2003 to 2007, driven by both strong investment and private consumption. The most dynamic economy was Serbia which grew by 6.1% on average during the past five years. It was closely followed by Albania, Bosnia and Herzegovina, Montenegro and Croatia. The Montenegrin economy accelerated very much in 2006 and 2007, against the backdrop of the foreign investment boom. The slowest economies were Kosovo and the former Yugoslav Republic of Macedonia, but like in the entire region their economies also picked up in the past two years. Growth is driven by a strong increase in private consumption in all economies but investment is also picking up steadily in most of them. The growth of labour productivity was more uneven during 2003-2007. A strong advance, in excess of real GDP growth, was recorded in Serbia, but also Albania, the former Yugoslav Republic of Macedonia and Bosnia and Herzegovina succeeded in keeping labour productivity more or less in line with economic growth.

Graph I.5.10: **Economic growth (%, avg. 2003-2007)**



Investment ratios are solid in most economies and moreover they are on an upward trend. In 2006, the share of investment in GDP was close to or above 20% in all economies. The investment ratio has increased rapidly in Croatia and Montenegro, driven inter alia by strong public investment, to around 30% of GDP. The current investment level in Albania is also growth enhancing, but is driven mainly by private initiative, while the level of investment in the Serbian economy is trailing the group

Graph I.5.11: **Investment ratio (% of GDP)**



6. CONCLUSIONS

The euro plays a key role in the economic and financial architecture of the Western Balkans. This is reinforced by the clear prospect of EU integration – be it a long-term one - and the need to achieve in due time the nominal convergence required by the EMU which provide an important anchor for political stability, structural reforms and foreign investment in the region. The widespread use of the euro as an exchange rate anchor in the Western Balkan economies is a main driver for the other functions played by the euro in terms of trade invoicing, official reserves, financial and parallel currency.

Five out of the seven economies are using fixed - de facto or formally - exchange rate arrangements, which range from official unilateral euroisation to the use of the euro as a de facto peg. Moreover, the use of the euro as parallel cash or financial currency is extensive in all seven economies, also reflecting a strong process of financial integration between the region and the euro area. In 2007, close to 75% of the stock of domestic credit was either denominated or indexed in euro, also considering Kosovo and Montenegro where the banking systems are quasi-euroised. The share of bank deposits denominated in euro is lower at around 60% of the total, but remains relatively important. Obtaining reliable data about the use of the euro as parallel cash is not straightforward, but it is estimated that the substitution rates range from about 20% to more than 50% in the region. Mainly due to geographic proximity and traditional economic linkages, which are in turn based on large relative comparative advantages, the European Union and in particular the euro area represents the most important trading partner of the Western Balkans. Moreover, the share of trade invoiced in euro is even higher than what trade shares with the euro area would suggest, as revealed by the limited data available.

The euro (initially the use of the DM as external anchor) has served the Western Balkan economies well. Both its official use as exchange rate anchor or reserve currency and its unofficial use as a store of value or financial currency by the private sector helped the economies restore and preserve macroeconomic stability after the turmoil of the break-up of ex-Yugoslavia. Later, when the transition to market economies accelerated the euro anchor became a catalyst for remonetisation of the economies, rebuilding of domestic savings and deeper financial and trade integration with the European Union. Despite the more complex macro-economic environment resulting from the heavy use of the euro for domestic lending or as parallel cash, it represents a natural development for economies which are preparing for EU accession and participation in the EMU. The euro as an external anchor, together with complementary stabilisation policies and the acceleration of structural reforms led in general to increased inflows of FDI and robust economic growth.

Nonetheless, the financial integration with the euro area and the use of external savings is not entirely free from macroeconomic and financial risks that could jeopardize the rapid catching-up process. External imbalances are large, thus raising concerns about the degree to which external competitiveness has been maintained. They are driven by significant capital inflows in the region, which partially reflect higher investment returns and take the form of FDI. Net FDI has been increasing as a share of GDP in the past five years and on average stood at around 7% of GDP, roughly covering about 60% of the average current account deficits. At the same time, the rising productivity and incomes triggered a consumption smoothing process based on booming credit growth, which accounted for the rest of the external imbalances. The lion's share of domestic lending occurs in foreign currency and is increasingly directed to households, which may engender systemic problems if the banks are not able to channel this resources primarily into productive activities or are not adequately regulated and supervised.

The recent volatility of international financial markets has not had a heavy toll on the Western Balkan economies so far. Like in the rest of the world, the stock exchanges recorded serious declines, differing from country to country and the growth of the money supply decelerated in most of the economies. On the other hand, the growth of credit continued to accelerate in some countries, while the slowdown in the other ones appears to be in line with the policy intentions of the authorities. A significant impact on the real economy is not visible yet, but it should not be excluded if growth in more advanced economies, in particular from the EU, would substantially slow in 2008 and 2009. An indirect transmission channel could be the inflows of FDI which may slow down due to, inter alia, a reduced availability of credit on the international capital markets and more pessimistic economic prospects. In that case, both the real economy and external vulnerability of the Western Balkans could be affected.

It thus becomes clear that in order to make the best use of the euro anchor and their European perspective and at the same time be prepared to deal with the fallout from the international financial turmoil, the Western Balkan economies cannot be complacent about the need for continued stability-oriented public policies.

A responsible fiscal policy should continue to be the cornerstone of macroeconomic policy and structural reforms that ensure flexible markets and productivity gains need to be accelerated, in order to ensure the smooth adjustment of relative prices. Creating and preserving an attractive business environment remains the best insurance that the volatility of financial flows is minimised and the impact of endogenous or exogenous shocks is contained. The broader EU anchor can help in this respect and the countries are gradually implementing the aforementioned stabilisation and structural reforms by adopting the sound economic policies required by the EMU framework and the fulfilment of the Copenhagen criteria, including the acquis communautaire.

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Part II

Fiscal consolidation in candidate and potential candidate countries

1. INTRODUCTION

The need for fiscal consolidation is often seen as a mantra of economic and fiscal policy prescriptions from third parties, notably the IMF. It is however not as such an economic policy objective, but rather a process aiming at establishing the desirable fiscal space. In the narrow sense, fiscal space can be defined as *"the room in a government's budget that allows it to provide resources for a desired purpose without jeopardizing the sustainability of its financial position or the stability of the economy"* ([1]). In the broader sense, fiscal space further aims at ensuring appropriate room for the private sector's development, which requires that local savings and capital inflows are not diverted to mainly finance the government sector. Moreover, in countries with a limited margin for full fledged autonomous monetary policies – i.e. the vast majority of small and medium-size economies – the budget is often, within the macroeconomic policy mix, the core policy tool of adjustment, and fiscal adjustment is therefore crucial to attain key macroeconomic adjustment objectives.

Thus, there is in a majority of countries – even though to a different extent – a high expectation on fiscal consolidation to deliver either (i) macro-economic adjustment, (ii) economic development and growth, (iii) more specific fiscal policy objectives such as limitations of general government spending or public debt, or usually a combination of those three objectives. This requires increasingly informed policy planning and well organised coordination within the government. The process is subject to ex-ante and ex-post fiscal surveillance from external stakeholders, including, in the broader sense, the financial markets. Economic and fiscal fundamentals, but also the extent to which this – implicit or explicit – process of fiscal surveillance is carried out in an orderly way do matter a lot, and influence the markets' assessment and behaviour, with eventual costs or benefits in terms of interest rates and price to pay for fiscal imbalances.

Within the European Union the co-ordination and surveillance of economic policies –notably fiscal policies – aim at ensuring that Member States regard their economic policies as a matter of common concern and conduct these policies with a view to contributing to the objectives of the Community, notably sustainable and non-inflationary growth, a high level of employment and social protection, convergence of economic performance and economic and social cohesion. The EU multilateral surveillance process, in which all member states take part, has become a major element for macro-economic policy making and co-ordination within the Union.

The objectives behind the EU economic policy co-ordination are also, mutatis mutandis, valid for third countries. The present paper examines various channels through which the EU has become an increasingly active stakeholder in the broader fiscal surveillance arena, encouraging fiscal consolidation, notably with the aim of diffusing stabilisation and economic growth to a cluster of countries geographically close to the EU, i.e. candidate and potential candidates countries, as well as potentially some of the benefits of macro-economic and fiscal policy planning and surveillance achieved within the Union. The paper further assesses main achievements as regards fiscal consolidation in this cluster of countries and recent improvements as regards public sector governance.

While it would be hazardous to draw a direct link between surveillance and EU accession objectives on one side and, on the other side, fiscal consolidation achievements, the paper concludes that the combined prospect of EU membership and narrow margins of manoeuvre as regards the macro-economic policy mix apparently had a strong incentive role in convincing candidate and potential candidate countries' fiscal authorities to adopt overall prudent fiscal policies. Sustained growth allowed for increased fiscal revenue and reduced deficits, which were more easily financed owing to numerous privatisation operations. The challenge for the near future will be in a number of countries to adjust the pattern of fiscal consolidation by limiting the size of government, thereby further opening fiscal space for a more sustained private sector development.

([1]) Heller, Peter S. 2005. “Understanding Fiscal Space”. IMF Policy Discussion Paper.

2. EU FISCAL SURVEILLANCE AND DIALOGUE FRAMEWORKS

This section describes the instruments under the EU's existing fiscal surveillance and policy dialogue framework for candidate countries and potential candidate countries, i.e. the Western Balkans and Turkey.

2.1. PRE-ACCESSION ECONOMIC PROGRAMMES (PEPS) AND FISCAL NOTIFICATIONS BY CANDIDATE COUNTRIES

Currently, there are three recognised candidate countries: Croatia, Turkey, and the Former Yugoslav Republic of Macedonia (FYRoM). Negotiations with the former two were opened on 3 October 2005. While the European Council has in December 2005 recognised the FYRoM as a candidate, the opening of negotiations has been delayed sine die, pending improvements of the country in complying with the Copenhagen accession criteria. As theses countries approach accession, they need to prepare for participation in the multilateral surveillance and economic policy co-ordination procedures currently in place as part of Economic and Monetary Union (EMU).

Sound budgetary policies and fiscal sustainability are of importance to all countries, but of particular relevance to countries with a perspective of EU membership in the medium- to long-term and which therefore prepare themselves to meet EU Member States obligations under the Treaty and the Stability and Growth Pact. To this end, a pre-accession fiscal surveillance has in recent years been put in place with candidate countries, which to a large extent mirrors the procedures used under the preventive arm of EU budgetary surveillance. Based on an annual fiscal notification and the submission of a Pre-Accession Economic Programme (PEP), the pre-accession fiscal surveillance constitutes an equivalent to Member States' bi-annual fiscal notification and their submission of convergence or stability programmes.

These instruments provide candidate countries with the opportunity to gradually adapt their fiscal policy framework to EU standards, provide support in preparation for EU membership, and facilitate peer reviews and policy recommendations. This co-operation has been mutually beneficial in preparing previous accessions, although the pre-accession fiscal surveillance in a number of cases has not been able to prevent the activation of the Stability and Growth Pact's corrective arm after EU accession.

Pre-accession Economic Programmes (PEP)

In view of EMU rules, one of the economic priorities already at the time of the previous enlargement wave was to bring in line within the candidate countries the reporting, monitoring and control of public finances, and specifically fiscal positions, with current EU procedures. In 2001, the Commission services initiated jointly with the candidate countries a new initiative, called the "pre-accession fiscal surveillance procedure". It follows closely, but in a simplified manner, the permanent fiscal surveillance procedures for member states. Under this procedure, candidate countries have to prepare Pre-Accession Economic Programmes, with the objective to outline an appropriate medium-term policy framework, including public finance objectives and structural reform priorities needed for EU accession. These programmes offer an opportunity to develop the institutional and analytical capacity necessary to participate in EMU, particularly in the areas of multilateral surveillance and coordination of economic and fiscal policies.

The procedure envisages an important multilateral dimension, including an opportunity for Member States and candidate countries to discuss the economic programmes. The candidate countries are invited to participate in a multilateral meeting with high-level officials from various ministries of finance. At this meeting, the Commission services present their evaluation of the respective economic programmes. Moreover the candidate countries may provide a written submission to the meeting, which can include inter alia an update on recent developments and a response to the Commission's preliminary evaluation. The Commission also submits to the ECOFIN

Council its assessment of the Pre-accession Economic programmes and the conclusions of the multilateral meeting. Finally, these findings are made public. ([1])

Accession to the EU does not require candidate countries to fulfil the Maastricht nominal convergence criteria, but to comply with the Copenhagen accession criteria ([2]) . In the pre-accession period, the primary concern is medium-term fiscal sustainability, rather than achieving any particular fiscal target. Therefore, the assessment of the deficit in terms of GDP is likely to be a function of the speed of structural reforms, the relative speed of economic growth, the extent of real convergence as well as the saving-investment balance of that country.

Fiscal Notifications

The smooth and effective functioning of Economic and Monetary Union requires a co-ordinated, multilateral surveillance approach to fiscal policy. This, in turn, requires a sophisticated information system for budgetary operations, relying on clear and commonly defined accounting standards, and good administrative and analytical capacity. Every six months, each Member State is required to prepare and submit to the Commission data on government debt, fiscal deficit levels and related data according to the ESA 95 accounting standard.

Since 2001, the candidate countries have been requested to make an annual notification along the same lines, with the aim of preparing them for accession. The format of this notification is basically identical to that currently undertaken by Member States, although the frequency is annual (instead of semi-annual for Member States). The exercise of pre-accession notification together with its evaluation serves several objectives. First, it ensures that each candidate country will be capable of complying with the ESA 95 national accounting standard by the date of accession. Second, the notification data, provided during the pre-accession period allow effective economic analysis of the current budgetary positions of the candidate countries. Third, the reporting and calculation of fiscal positions within the candidate countries progressively becomes comparable to those of EU Member States.

The Commission's Directorate General for Economic and Financial Affairs and Eurostat produce an assessment of these fiscal notifications which is published. ([3]) This assessment examines the quality and reliability of the notified deficit (or surplus) and debt figures, and of the degree of compliance of notified data with ESA 95 accounting requirements. There is widespread recognition that ESA95 is a complex and demanding statistical standard, which can under normal circumstances only progressively be met.

2.2. ECONOMIC AND FISCAL PROGRAMMES (EFPS) OF POTENTIAL CANDIDATE COUNTRIES

A procedure similar to the PEP one was established in 2006 with potential candidate countries from the Western Balkans (Albania, Bosnia and Herzegovina, Montenegro and Serbia), even though slightly lighter than in the case of candidate countries (notably without ministerial multilateral review) ([4]). Accordingly, each of these countries prepared and submitted by 1 December 2006 a first medium-term

([1]) In the Series of ECFIN Occasional papers, available on http://ec.europa.eu/economy_finance/publications/occasional_papers/2007/occasionalpapers31_en.htm

([2]) The Copenhagen criteria require that for membership, a "candidate country has achieved stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and, protection of minorities, the existence of a functioning market economy as well as the capacity to cope with competitive pressure and market forces within the Union. Membership presupposes the candidate's ability to take on the obligations of membership including adherence to the aims of political, economic and monetary union."

([3])http://ec.europa.eu/economy_finance/publications/occasional_papers/2007/occasionalpapers33_en.htm

([4]) Kosovo has not yet been required to submit such a programme. However, donors, including the EU, requested Kosovo to produce annually a Medium-Term Expenditure Framework (MTEF) which to a large extent serves the same fiscal surveillance purpose. Given the vulnerable situation of Kosovo's public accounts, the draft UN special envoy's settlement package suggested the establishment of a fiscal surveillance mechanism between the authorities and the Commission, in cooperation with the IMF, to ensure that Kosovo's public accounts remain on a sustainable track.

Economic and Fiscal Programme. As in the case of PEPs, the Commission assessment of EFPs is published. ([1])

2.3. ECONOMIC DIALOGUES WITH CANDIDATE AND POTENTIAL CANDIDATE COUNTRIES

Regular dialogues take place at technical level on macroeconomic and financial sector issues with a number of countries, in particular with the candidate countries and the potential candidate countries of the Western Balkan. These dialogues normally take place within specialised sub-committees created under the bilateral agreements concluded with these countries (association, partnership and cooperation, or trade and cooperation agreements). In the case of Turkey, an Enhanced Economic Dialogue has been established as an additional channel of communication.

While these dialogues can and do address a wide range of issues (real economic developments, monetary policy, fiscal policy and developments, structural reforms), fiscal issues figure prominently given the crucial role of fiscal instruments in the macro-economic policy mix in many of the partner countries that are confronted with limited discretion as regards monetary policy. An institutional element also influences the emphasis on fiscal issues, namely the prominent role of counterparts from ministries of finance in these dialogues. As a result, regular discussions take place with these various countries on recent fiscal developments, the outlook, and the main public finance management and tax reforms.

Recently the Commission has increasingly linked the substance of discussions in the dialogues with that of the PEPs and EFPs: the dialogues provide a useful opportunity to discuss bilaterally with these countries their economic and fiscal programmes. This bilateral format complements the multilateral policy dialogue which takes place once a year.

2.4. MACRO-FINANCIAL AND OTHER FORMS OF ASSISTANCE

Macro-financial assistance (MFA) is a policy-based financial instrument of untied and undesignated support to partner third countries. Macro-financial assistance is exceptional in nature and is mobilized on a case-by-case basis with a view to helping the beneficiary countries to deal with serious, but generally short-term, balance-of-payments or budget difficulties. It takes the form of medium- to long-term loans or grants (or an appropriate combination of the latter two) and generally complements financing provided in the context of an IMF programme. As a rule, the funds are paid to the Central Bank of the beneficiary country, but their final destination (build up of reserves, foreign exchange market interventions or direct support to the budget) is generally left to be decided by the authorities in agreement with the International Monetary Fund. Grant components of this form of assistance, if any, are normally channelled to the recipient country's budget.

Macro-financial assistance is combined with other EU assistance programmes in order to create synergies and to facilitate the implementation of structural reform measures. Disbursements are subject to conditionality. A significant share of conditions is in most cases related to public finance management and reform. Commission staff missions have regularly reviewed the economic and fiscal situation and the state of play as regards the implementation of the recipient authorities' policy undertakings. Thereby, while MFA has not primarily been a budget support instrument (with a few exceptions), it has contributed to budget consolidation in the broader sense.

Recently, macro-financial assistance has been mainly provided to the Western Balkans (63.5% of the operations decided from 1999 to 2002 and 72% for 2000-2007) and some low income NIS countries. Currently, there remains one active MFA operation, in favour of Kosovo, approved by the Council in November 2006.

([1]) Also as the precedent ones in the series "Occasional Papers":http://ec.europa.eu/economy_finance/publications/occasional_papers/2007/occasionalpapers32_en.htm

2.5. FISCAL SURVEILLANCE BY OTHER INTERNATIONAL STAKEHOLDERS

Fiscal consolidation has been an explicit aim of governments of Western Balkan countries and Turkey which, at the turn of the millennium, were in most cases faced with weak fiscal positions and medium to high public debt burdens. These domestic policies have been reinforced by cooperation and agreements reached with the International Monetary Fund (IMF), substantially contributing to macro-economic stabilisation and notably balance-of-payments and fiscal consolidation over the period (see below section 2.1 on fiscal consolidation outcomes).

In view of an improved macro-economic situation and outlook some Fund supported programmes, e.g. in Albania and the Former Yugoslav Republic of Macedonia, have put increased emphasis on structural reforms. However, recent developments in candidate and potential candidate countries suggest that the authorities, comforted with broadly successful stabilisation programmes and a more sustainable outlook of their balance of payments, have been less keen to engage into formal arrangements with the IMF, thus in a number of cases limiting their cooperation with the IMF to Article IV consultations and technical assistance.

Serbia, comforted with substantial FDI inflows has even made early debt repayments to the IMF, thereby reducing its external indebtedness, and de facto limiting the Fund's say on its economic and fiscal policy making. It also remains uncertain whether Turkey, the country that is currently the largest IMF borrower will be willing to engage into a successor programme after the current one has come to an end in May 2008.

Credit rating agencies also play a permanent role on the fiscal surveillance scene, since part of their assessment and ratings are geared towards monitoring sovereign lending risks and possible defaults on public debt.

Table II.2.1:

Credit and country-risk rating

	Standard & Poor's (1)	Moody's (2)	Fitch (3)	OECD (4)
Albania	n.a.	Ba1/Baa1/Stable	n.a.	6
Bosnia and Herzegovina	n.a.	B2/Ba3/Stable	n.a.	7
Montenegro	BB+/Negative/B	Ba2/n.a./Stable	n.a.	6
Serbia	BB-/Negative/B	n.a.	BB-	7
Kosovo (UN 1244)	n.a.	n.a.	n.a.	n.a.
Croatia	BBB+/Stable/A-2	A1/Baa1/Stable	BBB-	4
fYroM	BBB-/Stable/A-3	n.a.	BB+	5
Turkey	BB/Negative/B	BA1/Ba3/Stable	BB-	4

(1) Soverign local currency ratings (long term / outlook / short term).
(2) Government's foreign currency / local currency / outlook, bond ratings.
(3) Long-term local currency rating (LTFC) rating.
(4) The Country Risk Classification Method measures the country credit risk, i.e. the likelihood that a country will service its external debt by assessing country credit risk and classifying countries into eight country risk categories (0 best - 7 worst).

Table II.2.2:

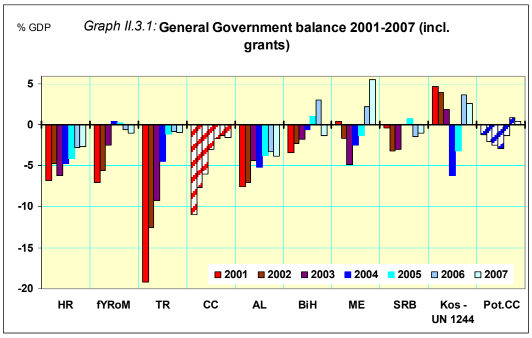
IMF programmes in candidate and potential candidate

Country / region	Programmes over 2000-2006 period	Current situation
Candidates		
Croatia	SBA; 03/2001-05/2002 SBA; 03/2003-04/2004 SBA; 08/2004-11/2006	Last programme expired in November 2006.
The former Yugoslav Republic of Macedonia	EFF; 29/11/2000 – 22/11/2001 SBA; 30/4/2003 – 15/8/2004 SBA; 31/8/2005 – 30/8/2008	Current programme treated as pre-cautionary facility after the first tranche withdrawal in September 2005
Turkey	SBA 22/12/1999 – 20/12/2001 of which SRF 21/12/2000 – 20/12/2001 SBA 04/02/2002 – 03/02/2005 SBA 11/05/2005 – 10/05/2008	Final review completed on 10 May 2008. Until further notice, Turkey is subject to Post-Programme monitoring.
Potential candidates		
Albania	ESAF[1]/PRGF 13/05/1998 – 31/07/2001 PRGF 21/06/2002 – 11/20/2005 EFF[2] 01/02/2006 – 31/01/2009 and PRGF[3] 01/02/2006 – 31/01/2009	IMF review mission to visit Tirana early November 2007. Following an understanding on required policy measures, fourth review under the combined PRGF and EFF was approved by the Board in Jan. 2008.
Bosnia and Herzegovina	SBA May 1998 – May 2001 SBA August 2002 – February 2004	Last programme expired in February 2004
Montenegro	No programme since the independence of Montenegro (June 2006).	Currently no programme
Serbia (before 2006, Serbia-Montenegro)	SBA, June 2001-May 2002 EFF, May 2002 – Feb 2006	Last programme expired in February 2006.
Kosovo (under UNSCR 1244)	After the Constitution of the Republic of Kosovo entered into force on 15 June 2008, Kosovo applied for IMF membership. Cooperation with the Fund was previously formalised through an understanding on a Memorandum of Economic and Fiscal Policies (MEFP) and a Letter of Intent (November 2005).	An Memorandum of Economic and Financial Policies agreed in November 2005 laid out a fiscal framework. IMF staff and authorities have since then continued discussions with the intention to negotiate a new understanding. However, currently no such understanding is in place.

[1] ESAF – Enhanced Structural Adjustment Facility
[2] EFF – Extended Fund Facility
[3] PRGF – Poverty Reduction and Growth Facility

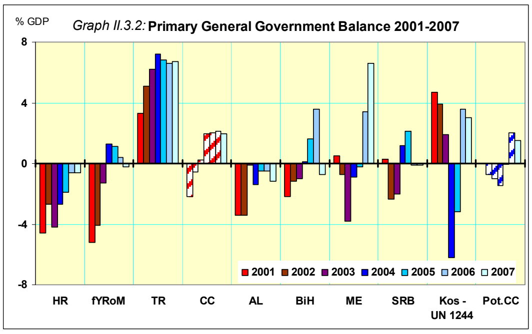
3. RECENT FISCAL DEVELOPMENTS IN THE COUNTRIES

3.1. PATTERNS OF FISCAL TRENDS AND CONSOLIDATIONS



Graph II.3.1: **General Government balance 2001-2007 (incl. grants)**

Fiscal positions have markedly improved in candidate and potential candidate countries since 2000. In each of the three candidate countries the general government deficit was progressively reduced over the period of 2002-2006, after a hike in 2001 which had no clear common ground. This improvement remained modest in Croatia where the deficit reduction has been rather gradual and more visible towards the end of the period. In Turkey, fiscal consolidation was spectacular as the deficit was reduced from record levels in 2001 (20% of GDP) turning into a slight surplus in 2006. In the former Yugoslav Republic of Macedonia, after a deterioration of the situation in 2001 largely due to civil unrest in the country, a quite drastic fiscal adjustment took place and the budget balance turned positive in 2004 and has remained close to balance since then. Among potential candidate countries, the overall trend has also displayed a significant degree of consolidation with the general government balance improving from close to -5% to a slight surplus and the most spectacular improvements taking place towards the end of the period between 2005 and 2007. However, the patterns of this overall favourable trend were quite different across countries. Bosnia and Herzegovina achieved a turnaround of its fiscal balance by almost 10 percentage points (from -7% to +3% of GDP) between 2001 and 2006. This however came to an end in 2007 with a significant fiscal slippage. Albania achieved a rather steady reduction of its public deficit. The series are less reliable in the case of Serbia and Montenegro, given the biased deficit data for 2000, but both countries ended the period with reduced deficits or in surplus (Montenegro). In the case of Serbia, however fiscal consolidation was partially reversed in 2006 and 2007 in light of several up coming elections. Kosovo, which under the UN mandate could not so far borrow, remained a particular case with episodes of positive fiscal outcomes leading to the accumulation of cash deposits, followed by episodes of depletion of these reserves. Overall, in both candidate and potential candidate countries, the number of favourable episodes (defined as annual improvements in the general government balance) markedly outweighed the negative ones. Reversals (i.e. deteriorations that follow improvements) were in most cases short lived (only one year).

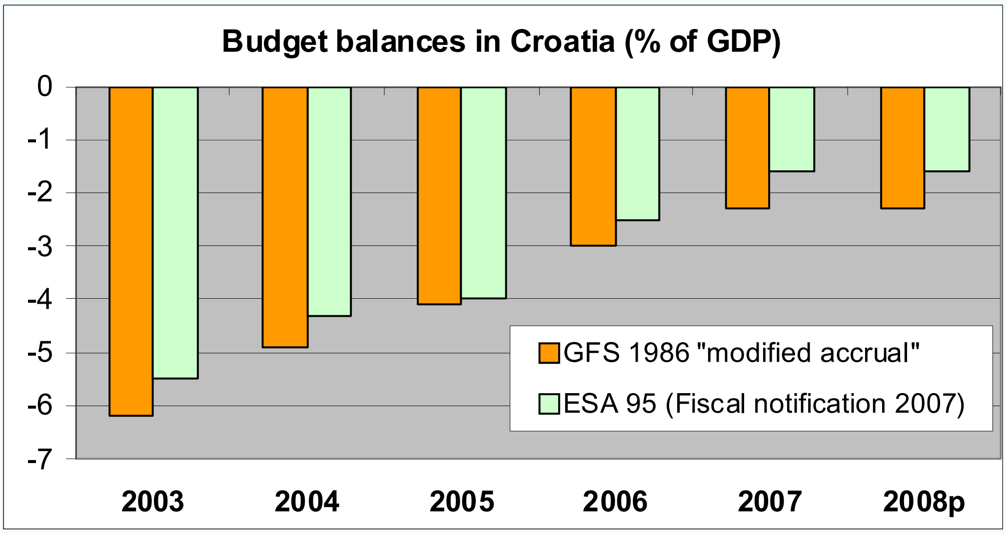


Graph II.3.2: **Primary General Government Balance 2001-2007**

This overall favourable trend mirrors a sharp reduction in primary deficits, or increase in primary surpluses. Both groups of countries (candidate and potential candidate countries) ended the period with an average (non-weighted) primary surplus. The average primary balance turned positive in candidate countries in 2003. It dramatically increased in Turkey which was able to comply with the 6.5% primary surplus fiscal rule between 2003 and 2006 that was agreed with the IMF in view of the country's high debt burden. The government has however recently announced a policy shift, with increased capital expenditure and primary surpluses expected to be gradually reduced down to 2.4% in 2012. In Croatia, the primary deficit has been falling since 2004 and came close to zero in 2006. The former Yugoslav Republic of Macedonia, exhibiting a more modest level of public debt, achieved a primary balance surplus in 2004, which was slightly reduced in the following years. In potential candidate countries, primary balances also markedly improved. In Serbia and

Box II.3.1: **DATA DO MATTER :**
THE INFLUENCE OF PUBLIC ACCOUNTING METHODOLOGY IN THE CASE OF CROATIA

The concept for reporting the fiscal deficit which is mostly used in official publications and in the press and therefore best known to the general public in Croatia is referred to as the deficit on a "modified accrual basis". It is based on GFS 1986 standards and applies partial accrual's accounting for some items on the spending side. This concept was used as the main policy target to be observed under IMF programme implementation between 2004 and 2006. It is still largely referred to in domestic public discussions on fiscal policy as well as in analytical papers and reports issued by international institutions.

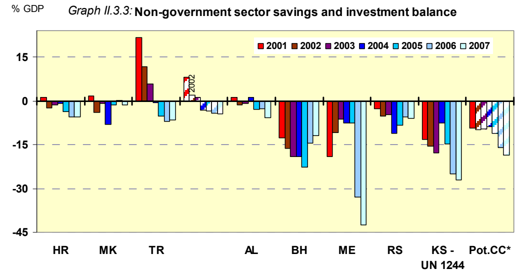


At the same time, over the past years, Croatia has undertaken important steps with a view to aligning budget reporting with EU Accounting standards (ESA 95). In the context of the annual Pre-Accession Fiscal Notifications, which are part of the Pre-Accession Fiscal Surveillance Procedure, the Croatian Ministry of Finance has reported fiscal deficit and debt figures to the European Commission on an annual basis since 2005. While the first submission in 2005 was still based on GFS methodology, the notifications submitted in 2006, 2007 and 2008 were based on ESA 95, reflecting gradual progress in improving quality of data and meeting EU requirements. In its assessment of the 2007 data submission , the European Commission acknowledged considerable progress made and pointed out that further efforts were needed in order to ensure full ESA 95 compliance. Remaining deficiencies were identified in the (still partial) application of accrual accounting, in particular with respect to the recording of taxes, guarantees and debt repayments to pensioners. At the same time, the assessment noted that the well-established use of GFS methodology in the government finance statistics should provide some reassurances to the overall quality of the data.

As a matter of fact (see graph), deficits calculated according to GFS and ESA 95 methodologies show a similar trend of a gradual deficit reduction over recent years. The size of the deficit is different, but the difference is relatively small in most years. Deficits as calculated under GFS are larger in each year as compared to the ESA 95 equivalent. Among a number of methodological reasons, this seems largely due to the fact that capital revenues, i.e. gross disposals of non-financial assets, are treated as a financing item "below the line" under GFS, while ESA 95 treats them as revenues "above" the line with a deficit reducing effect.

Montenegro, after an initial deterioration in 2001 (at the time the Federal Republic of Yugoslavia resumed the servicing of debt on which it had defaulted under the previous regime), a sharp improvement took place, supported by the debt restructuring agreement of 2001 (see below). Bosnia and Herzegovina, faced with substantial contingent liabilities which may inflate public debt and windfall revenues following the introduction of VAT, achieved a surplus of 3%

of GDP in 2006. However, a reversal of this favourable outcome took place in 2007 on the back of expansionary fiscal policies. Albania improved its primary balance position over the period which turned close to zero in 2006. Latest developments point to a number of fiscal policy reversals, with a looser fiscal stance in Albania, Bosnia and Herzegovina and Serbia.

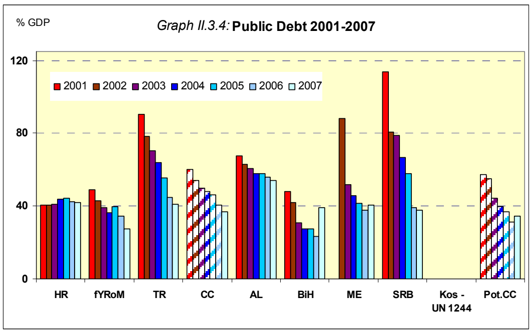


Graph II.3.3: **Non-government sector savings and investment balance**

The extent to which this overall improvement in budget balances is providing increased financing space for private sector driven development and growth varies across countries, also impacting on current account developments over the same period. In a majority of candidate and potential candidate countries, current account deficits widened sharply over the period, also mirroring strong capital inflows and vigorous GDP growth. Among these countries the only one to have recorded a reduction of the non-government savings and investment balance over the period is the former Yugoslav Republic of Macedonia, where fiscal consolidation went back to back with an improvement in the current account balance. This consolidation of the current account however also reflects a rather modest growth performance of the country. In Turkey, following the sharp 2001 recession (-9.5% drop in GDP) growth resumed in 2002 and in spite of reduced general government deficits a widening of the overall (current account) and non-government savings and investment balance was recorded. Elsewhere, vigorous growth over the period also triggered increased deficits of the current account and of the non-government savings and investment balance, except in Kosovo which recorded both slow growth and high imbalances.

3.2. DEBT DYNAMICS

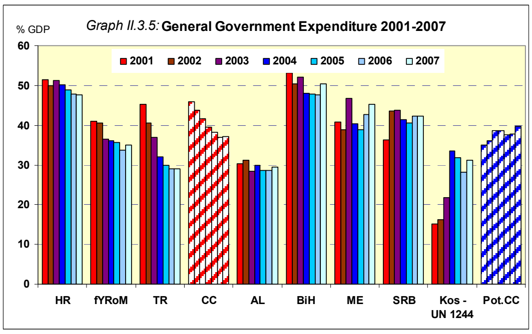
Public indebtedness has overall markedly decreased in recent years in both candidate and potential candidate countries. Within the group of candidate countries, public debt fell sharply in Turkey after a last hike in 2001, mirroring the drastic fiscal consolidation which has meanwhile taken place with sizeable primary balance surpluses. In Croatia however, the public debt stock steadily increased until 2005, in line with the lack of vigorous fiscal adjustment policies. In potential candidate countries, public debt ratios (to GDP) sharply decreased, particularly in Serbia and Montenegro where this was facilitated by the generous 2001 debt rescheduling of the Paris Club (reduction of debt by 2/3) – also followed by a debt rescheduling agreement with London Club creditors- both of which took fully effect in 2006 upon the satisfactory completion of the IMF programme. Since 2004, improvements in the fiscal balance have further supported a decrease in public debt levels. On the back of substantial privatisation revenue inflows, the Serbian government has made in 2006 and 2007 early debt pre-payments to the IMF and World Bank. In Bosnia and Herzegovina external public debt fell sharply as a share of GDP, a process supported by the rescheduling agreements with the Paris Club and London Club group of creditors in 1997/1998, the large extent of new borrowing on concessional terms, relatively strong GDP growth and a sizeable fiscal consolidation until 2006. This trend was somewhat reversed in 2007, when fiscal policy turned substantially more expansionary. However, a large amount of unsettled domestic liabilities will add to the current moderate public debt stock figures and calls for the continuation of cautious fiscal policies. Albania also saw a decrease of its public debt ratio over the period, even though a less dramatic one, supported by steady decreases in its fiscal deficit.



3.3. THE COMPONENTS OF RECENT FISCAL ADJUSTMENT

The size of the public sector, measured as general government spending relative to GDP, varies significantly across candidate countries and potential candidate countries. The three candidate countries achieved some downsizing in government spending (in GDP percentage terms) over the past few years. Among candidate countries, Croatia remains the one with the highest share of general government spending, amounting to 47.8% of GDP in 2006 (compared to 51.5% of GDP in 2001). In the former Yugoslav Republic of Macedonia and Turkey the size of the public sector is relatively modest (around 34% and 30% of GDP respectively).

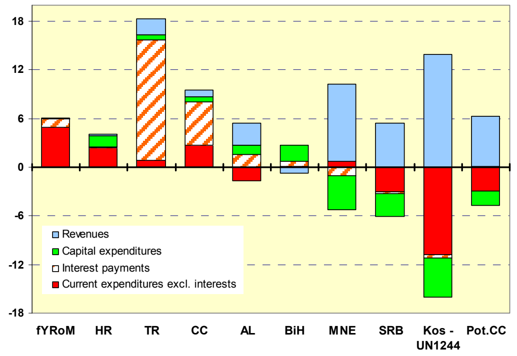
In potential candidate countries, the situation is uneven. In Albania a modest and rather stable size of general government (around 28% of GDP) may have been conducive to the relatively dynamic private-sector led growth of the country over recent years.



Kosovo also has an overall low level of general government expenditures (28.1% of GDP in 2006) but the size of the civil service in terms of its share of total government expenditure is large (12% of GDP). Downsizing the relative weight of current expenditure would be required to make room for a larger share of capital expenditure financed from the budget. In Bosnia and Herzegovina, public spending declined from the beginning of the decade, largely driven by the reduction of foreign financed investment projects. The trend was however reversed in 2007 and government spending reached 50% of GDP, a level which calls for significant downsizing. In Montenegro and Serbia the relative size of general government expenditure is somewhat lower (2006: 42.6% and 42.5% of GDP respectively).

Fiscal adjustment in candidate and potential candidate countries has over the period been mainly achieved through revenue increases rather than expenditure reductions. To a large extent, the increase in revenues was driven by the overall buoyant economic activity in the context of benign external conditions. Therefore, it is less clear how meaningful the consolidation in cyclically-adjusted terms would be. As for candidate countries, there is a quite different pattern of the fiscal adjustment during 2000-2007. The sizeable fiscal adjustment in Turkey was based on both lower interest payments and revenue improvements. In Croatia a 2.8 percentage points of GDP improvement of the budgetary balance was mainly achieved with higher revenues, a feature which is not the desirable one in view of the already substantial size of government. For the former Yugoslav Republic of Macedonia, the mild deterioration of the fiscal balance (2.4 percentage points of GDP in 2000-2006) was caused by some decrease in government revenues and a mild increase of current and capital expenditures at the same time. Among potential candidate countries, BiH pursued a significant fiscal adjustment, mainly based on a reduction of expenditures, which was however reversed in 2007. Albania's fiscal adjustment resulted from a decrease in interest payments and from higher revenues. The other potential candidates increased their government revenues markedly in the period from 2000 to 2006 and, to a lesser extent, government expenditure.

Graph II.3.6: **Composition of fiscal adjustement (GDP % change 2001-2007)**



Fiscal adjustment in the candidate and potential candidates has thus mainly been based on increases in revenues. Tax policies pursued and changes introduced, including in tax management, contributed to this overall increase. The situation is however uneven across countries. In Turkey and former Yugoslav Republic of Macedonia the levels of government revenues are relatively low. Turkey is characterised by low tax compliance (partly reflecting weak enforcement), but good progress has over the period been made in the area of tax administration. A still ongoing personal income tax reform as well as new legislation on corporate income tax aim at simplifying taxation, primarily by decreasing the number of rates and expanding the tax base. In the former Yugoslav Republic of Macedonia, the fairly good fiscal performance was achieved in spite of a reduction in government revenue, thus maintaining a light government burden. Efforts in improving the efficiency of administration and simplifying the tax system continued. Lately the country's authorities have embarked on an ambitious tax reduction programme, while keeping expenditure levels constant. In order to stimulate investment and economic growth a flat rate on personal and corporate income was introduced in January 2007. The rates for these two taxes were reduced to 12% and a further decrease to 10% is envisaged for 2008.

In the case of Croatia, the benign revenue performance over the recent period was largely driven by cyclical factors rather than by systemic changes in the tax system and, as expected in a country with relatively large public spending, the tax burden is heavy with a share of total revenues to GDP of around 40%. Revenue generation relies heavily on the taxation of consumption and labour, the latter driven by relatively high social security contributions. VAT remained an important revenue source, currently representing 60% of total tax revenues, complemented by significant excise duties (20% of total tax revenues). The Croatian tax regime has remained broadly unchanged over recent years with the exception of a significant overhaul of corporate income taxation and changes to personal income taxation , as well as some limited amendments to VAT , which are unlikely to have major effects on the size and composition of revenues.

As for the potential candidate countries, Albania is moving from a relatively sophisticated tax system towards a more simplified one with a broadened tax base and the tax administration becoming more effective. In Bosnia and Herzegovina, the function of indirect taxation was transferred to the state level under the auspices of the Indirect Tax Authority and a unified customs law and value added tax rate of 17% have been implemented recently. Direct taxation in that country is determined at entity level and is undergoing important changes. In Montenegro, the authorities' policy aims at decreasing some distorting taxes. The Serbian authorities further aim at widening the tax base and recently introduced changes in the tax system, mainly lowering the tax burden on labour and improving tax administration by reducing tax evasion. A significant degree of fiscal consolidation has been achieved in Kosovo by raising tax revenues, mainly from indirect taxes (VAT, excise, customs) collected at the border, which represent roughly three quarters of overall tax revenue.

Overall, it is clear (notably from graph I.3.6 above) that the pattern of fiscal consolidation has been significantly different in candidate and potential candidate countries, with the first achieving fiscal consolidation both from increased revenue and –even more- reduced expenditure and the latter having based their improved budget outcomes on buoyant revenue, while both current and capital expenditure increased. The extent however to which the improvements are structural cannot be fully assessed in the absence of estimates of cyclical components –which play a lesser role in catching up economies than in the EU member states - and output gaps. Future research would further also need to fully clarify the extent to which credit-financed booms in consumption as well as in the construction sector –as opposed to one of the other main sources of financing, remittances which rather feed into the informal economy- have led to GDP growth being "tax-rich"[(1)], a trend which if confirmed will eventually dwindle out.

([1]) The Commission's report "EMU@10: successes and challenges after 10 years of Economic and Monetary Union" has identified a similar temporary increase in implicit tax elasticities during housing booms or the catching-up phase of several countries converging towards the euro, which may mislead policy makers into believing that available resources are permanent.

4. DEVELOPMENT OF FISCAL GOVERNANCE AND INSTITUTIONS IN THE COUNTRIES

4.1. ADOPTION OF FISCAL RULES

Fiscal rules can contribute to fiscal consolidation and macro-economic adjustment, by committing the authorities to a target and signalling to the wide public, in particular financial markets, that a benchmark exists on which to assess the authorities' compliance with their own programme, thereby improving the government's accountability on its commitments. They may be a powerful instrument to influence the economic agents' expectations, in particular as regards price developments and interest rates. Following elections, a fiscal rule adopted under an outgoing government may be difficult to challenge or to call off.

Throughout the long process of pre-accession, the EU's EMU fiscal rules influence the candidate and potential candidate countries' policy setting. However, even in the case of candidate countries, the EU is not requesting compliance with EMU fiscal rules before accession. Moreover, at an early stage of transition these rules may not always be tailored to the economic and fiscal situation of the relevant countries. While the adoption of appropriate fiscal rules ultimately lies with the authorities of each country, the IMF has in a number of cases insisted on their very strong signalling effect having the potential to lend/increase credibility to the authorities' undertakings.

Among candidate countries, a fiscal rule was adopted in Turkey: the government targeted, as of 2002 and in agreement with the IMF, a 6.5% of GNP primary surplus of the general government sector. Until 2006, this rule has successfully contributed to fiscal adjustment and supported the dis-inflation process. In 2007, a year of elections, the rule was not met. As from 2008, a new medium-term fiscal framework will be in place, whereby the primary surplus will be gradually reduced from 3.5% of GDP in 2008 to 2.4% in 2012.

Kosovo under the UNMIK authority has not had recourse to public borrowing, which has implied stringent constraints, i.e. that a budget deficit can only occur if available donor support or cash surpluses from previous years can finance it. A de facto current expenditure rule was also introduced in Kosovo as part of the Letter of Intent agreed with IMF staff in November 2005, in spite of Kosovo under UN status not being an IMF member, and the Letter of Intent having less a formal nature than a full fledged programme. According to this rule, real expenditures must not grow more than 0.5% per year. The rule was effectively implemented in the 2006 and 2007 budgets. Its role was further enforced by the obligation to decrease the number of persons on the government's payroll by a pre-specified amount. A comparable rule is expected to be maintained in the context of a new understanding to be reached with the IMF, currently being discussed.

Limitations to local government borrowing have been established over the period in the former Yugoslav Republic of Macedonia, following the enactment of a law on local government finance and in Serbia where local government borrowing was restricted to the capital investment part of local governments' budgets.

4.2. IMPROVING PUBLIC FINANCE MANAGEMENT

Budget formulation and execution.

Public accounting systems have in most countries progressively been enhanced over recent years, with the introduction of international standards. In most cases, candidate and potential candidate countries first introduced GFS standards, often influenced by close IMF fiscal surveillance in the context of Fund supported programmes. Fiscal data are however not yet everywhere fully compliant with GFS 2001 standards. As regards candidate countries, the EU perspective already leads to the progressive adoption of ESA 95 standards: among the three current candidates, Croatia was the first one, in 2006, to publish government data according to ESA 95 standards. The former Yugoslav Republic of Macedonia was still at this stage upgrading its government accounting to GFS 2001 standards, which are also those used by Turkey for its budget.

Multi-annual budgeting is a key policy and planning instrument enabling the explicit prioritisation of policy actions within the overall budget constraint. It facilitates and clarifies choices, as well as annual budget programming, and may facilitate the adoption of a policy response to sustainability challenges. The establishment of PEPs and EFPs (as indicated above) at the request of the Commission is another reason for the introduction of multiannual budgeting in a number of these countries.

The three candidate countries have already put in place medium-term (mainly three-year) economic and fiscal frameworks. Turkey in particular, which has a central planning institution –the State Planning Organisation-, has well established planning tools, and the three-year fiscal programme as well as annual budgets are prepared on the basis of medium term projections and a medium term financial plan. This three-year framework is completed by a five-year Development Plan. Turkey and the former Yugoslav Republic of Macedonia also had three-year IMF Stand-By Arrangements in place, which have ended in Turkey in May 2008 and are about to come to an end soon in the former Yugoslav Republic of Macedonia.

In potential candidate countries, multiannual planning has also been supported by recent IMF programmes. Albania is currently in the last year of an IMF supported multiannual PRGF programme. Serbia, after the IMF board conclusion in February 2006 of a multi-annual EFF programme, continued to adopt annually a "budget memorandum" with a three-year fiscal policy framework. In 2006, the four potential candidate countries prepared for the first time a three-year EFP. In the case of Kosovo, it has been considered essential in liaison with the main donors for the Kosovan authorities to adopt annually a Medium-Term Expenditure Framework (MTEF) that consolidates budget and off-budget public expenditure and revenue and is a useful planning tool facilitating the identification of expected financing needs: the first MTEF was adopted in March 2006 and has been followed by a second one in September 2007 for the period 2008-2010, and more recently a third one in June 2007 covering the period 2008-2011.

Single Treasury Accounts.

The centralisation of government financial transactions in a single account in the ministry of finance is a pre-requisite for orderly cash and debt management, and thus often one of the first measures to be introduced in transition economies. Among candidate and potential candidate countries, the latest one to establish a single treasury was Montenegro (2002). In 1999, UNMIK had created a treasury single account in Kosovo, albeit with a number of sub-accounts.

However, a number of extra-budgetary funds often remain, typically for the holding and management of health, pensions and social contributions and payments, and in a number countries for investments in specific areas (e.g. road investment fund in the former Yugoslav Republic of Macedonia, defence industry investment fund in Turkey), or to hold privatisation receipts (e.g. Kosovo where they are held on Trust funds). Other numerous off-budget accounts continue to exist in a more limited number of countries (notably the former Yugoslav Republic of Macedonia,) a situation which not only reduces the transparency and accountability of public accounts and limits possible gains from optimised cash and debt management, but which may also increase the risk of outright cash mismanagement and waste.

Public finance internal control and audit.

Increasing emphasis is being put on internal control and audit in public administrations throughout the world, as a key element of enhanced public financial management, and this also applies to the cluster of countries under consideration. Recently, some concrete steps towards the establishment and efficient implementation of public finance internal controls and audit have taken place in candidate countries. As regards external control, the degree of development of the state audit institutions and systems varies across the countries. For example, while in Croatia the State Audit Office and the external audit in general meet the requirements of the International Organization of Supreme Audit Institutions (INTOSAI) auditing standards for effective and efficient audit of public finance and resources, in former Yugoslav Republic of Macedonia the coresponding functions are still in the process of being established and need further institutional strengthening. In potential candidate countries the situation is at an even earlier stage of development as regards both internal and external audit and controls.

4.3. NON-INFLATIONARY FINANCING OF PUBLIC DEBT

Limitations to monetary financing of public debt are a crucial element of sound fiscal policies. In the countries of former Yugoslavia in particular, the legacy of public deficits monetisation and subsequent hyperinflation in the 1990's raised public awareness on the flaws of lenient policies in this respect and has facilitated the establishment of a sounder environment in the newly independent republics. Lessons from previous painful crisis have also been learnt in Turkey, where legal changes introduced in 2001 prohibit central bank financing of the government. As a matter of fact, national legislation on central banks in both candidates and potential candidate countries is to a significant extent aligned with the EU Treaty's provisions prohibiting the central bank to finance public debt. In all three candidate countries, laws regulating central bank activities forbid lending to different bodies and levels of government, or as in Croatia also to the public sector. This is also the case in potential candidate countries, except in Albania, where the central bank is allowed to provide short-term loans to the government. Under the present currency regime - with the euro as legal tender- the Central Bank of Kosovo is not an issuing monetary authority and cannot provide any credit facility.

5. CONCLUSIONS

While it would be hazardous to draw a direct link between surveillance and EU accession objectives on one side and, on the other side, fiscal consolidation achievements, the combined prospect of EU membership and narrow margins of manoeuvre as regards the macro-economic policy mix appears to have had a strong incentive role for candidate and potential candidate countries' fiscal authorities to adopt overall prudent fiscal policies.

Sustained growth allowed for increased fiscal revenue and reduced deficits, which were more easily financed owing to numerous privatisation operations. In candidate countries –contrary to developments in potential candidates- improvements in fiscal balances were also achieved through a limitation of government spending. In the absence of estimates of output gaps and structural balances it remains however difficult to fully assess the extent to which these improvements were purely cyclical or also of a structural nature.

For South-East European countries, the challenge for the near future will be to adjust the pattern of fiscal consolidation by limiting the size of government, thereby further opening fiscal space for a more sustained private sector development.

Over the medium-term, further challenges will remain in particular in light of large expected liabilities, stemming partially from property restitution in several countries, contingent liabilities, and demographic developments with a rapid ageing of societies except in Turkey, Albania and Kosovo which have a young population. In addition, growing macro-economic imbalances and external and financial vulnerabilities in several countries will require a more restrictive policy response.

While monetary policy would normally be expected to deliver adjustments which are unlikely to be attained with the announced fiscal policy, the lack of effective monetary transmission mechanisms – largely due to the high degree of euroisation in several cases – will not make it possible for monetary policy to adequately match fiscal policy in containing rising external imbalances. The onus within the macro-policy mix is thus expected to remain on fiscal policies to address these imbalances.

On the other hand, as structural reforms are the most crucial driver of competitiveness over the medium- and long-term, improving policy planning will require more attention to be devoted by home authorities to the interaction between fiscal policies and structural reforms. The Commission can contribute to enhancing this articulation by setting clear requirements in this respect.

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