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The Western Balkans in Transition

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FOREWORD

This is the seventh issue of the "Western Balkans in Transition", which was coordinated by staff within the Unit "Economies of Candidate and Potential Candidate Countries" in the European Commission's Directorate-General for Economic and Financial Affairs – Directorate for International Economic and financial Affairs.

The main purpose of this publication is to give an overview of recent macroeconomic and structural developments in the countries of the Western Balkan region. The first two chapters of the issue include contributions on topics that represent a common challenge for all the economies, while the third one features a brief country-by-country economic assessment.

The first chapter on recent economic developments in the Western Balkans underlines that widening external imbalances, increasingly financed by private external borrowing, have raised the region's exposure to present unfavourable foreign capital markets conditions. In 2007 economic developments were overall favourable and remained sustained in the first half of 2008. However, since the last quarter 2008 and beginning of 2009 it has become obvious that the crisis will severely affect the region. Wide imbalances both on the side of balance of payments and fiscal accounts will require significant adjustments and call for a reassessment of the policy mix. However, in view of the lack of effectiveness of monetary transmission mechanisms in most countries, monetary policy is not expected to provide a policy response that is commensurate to the challenge. While fiscal policies would hence be expected to provide the bulk of the needed counter-cyclical adjustments, the large scale external imbalances of those small-size economies considerably limits the scope for fiscal stimulus measures. Falling budget revenue is on the contrary expected to require expenditure cuts. This sets the scene for difficult months ahead in the Western Balkans. This introductory section was co-authored by the economists of the Unit working on the various countries of the region (Bernhard Böhm, Frank Kohlenberger, Mihai Macovei, Christophe Pavret de la Rochefordière, Antonio Sanchez, Uwe Stamm, Harald Stieber, and Ulrich Windischbauer).

The second chapter on the role and patterns of investment looks more in-depth into private investment trends in South Eastern Europe (SEE), and explores some determinants of private investment, such as the financing sources for investment, the contribution of FDI and the role of public investment. This chapter shows that investment rates in SEE are substantially lower than among EU Central and Eastern European countries and the fast growing East Asian economies, which could explain partly the slower economic growth in SEE. Investment levels have only started to increase in recent years in most SEE countries. Private investment, which usually drives productivity gains and should have a leading role, has been particularly low. Hence, achieving higher investment rates, and a better quality of investment, is an overarching objective and this poses an important challenge for policy makers in SEE. The chapter mainly covers Albania, Bosnia and Herzegovina, Croatia, the former Yugoslav Republic of Macedonia, Montenegro, Serbia, and Kosovo (UNSCR 1244). Other countries, in particular Bulgaria, Romania and Slovakia, are partly included in the analysis for comparison and reference purposes. This second chapter on the role and patterns of investment in SEE was drafted by Borko Handziski from the EC-World Bank Joint Office for South East Europe.

The country sections give an update of the economic development and reform in the countries in the region. The country analysis were prepared by the respective desk officers: Laura Ruud and Harald Stieber (Albania), Mihai Macovei and Ulrich Windischbauer (Bosnia and Herzegovina), Uwe Stamm (Croatia), Bernhard Böhm (the former Yugoslav Republic of Macedonia), Antonio Sanchez (Montenegro), Frank Kohlenberger (Serbia), Harald Stieber and Ulrich Windischbauer (Kosovo UNSCR 1244).

The authors are grateful for the valuable comments and suggestions received from José Leandro, Johan Baras, Peter Grasmann, Antonio de Lecea and, as regards the second chapter on investment, a number of World Bank colleagues (Ardo Hansson, Sanjay Kathuria, Matija Laco, Evgenij Najdov, Lazar Sestovic, Matthew Verghis, Danijela Vukajlovic-Grba, Marina Wes, and Juan Zalduendo). This study is also being published in parallel in the World Bank Working Papers series (N°159, 2009).

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Part I

Recent Economic Developments in the Western Balkans

I. RECENT ECONOMIC DEVELOPMENTS IN THE WESTERN BALKANS

Growth in the Western Balkans remained sustained until mid-2008 overall and, in a number of countries, until the very end of 2008. Croatia, followed by Serbia and Montenegro, was the first country to be affected by the global economic and financial crisis in the third quarter of 2008. With increasing evidence that no country will remain immune from this crisis, domestic authorities are gradually realising that the drastic change in their growth trajectory will challenge current planning assumptions and policies, and require a new policy mix. However, the authorities – particularly in those countries that still enjoyed sustained growth until the end of 2008 – have not yet fully contemplated the scale of the adjustment needed. This is delaying action, notably in the fiscal domain.

The present chapter:

- looks at where the countries of the Western Balkans stood at the end of the 2000-2008 period and notes that, while growth was sustained and even accelerated towards the end of the period, and many successes were achieved in terms of macroeconomic stabilisation and structural reforms, the growth model that many countries pursued had a number of weaknesses – including large scale external imbalances – that may now exacerbate the region's exposure to the crisis;

- examines the first signs of the crisis that is now affecting the region;

- outlines the main expected channels of transmission of the crisis in the region, i.e. the rapidly shrinking external demand, the adjustment of external imbalances due to the global re-pricing of risk, the possible deleveraging and the financial sector's refinancing needs, which all impact domestic demand;

- takes stock of the first crisis response measures adopted by the national authorities;

- discusses the severe constraints on the policy mix – characterised by limited room for manoeuvre in monetary policy as well as fiscal policy – which make it difficult to deliver the form of policy response that is being adopted in the US and the EU, which combines a lowering of interest rates and fiscal stimulus packages.

While this chapter does not propose any detailed policy prescriptions it endeavours to raise awareness of the formidable challenges ahead, and the need for a fresh look at the new situation created by the crisis in the region. It is thus meant to provide a useful contribution to the current debates and much-needed reassessments.

I.1. RECENT GROWTH PATTERNS : A VULNERABLE GROWTH MODEL

I.1.1. Growth was sustained in recent years and even accelerated until mid-2008

After accelerating in 2007 to an average pace of 6.3% of GDP, growth in the Western Balkans declined in the second half of 2008. Economic activity was driven by strong domestic demand and fuelled by credit and wage growth. In contrast, the contribution of net exports to GDP growth remained negative in all the countries of the region. Recent data indicate that growth continued in 2008 but at more moderate levels. Croatia already witnessed a significant deceleration in the third quarter of 2008 due to much slower domestic consumption. On the supply side, services and in particular financial intermediation, telecommunications, transport, and trade were the sectors with the highest contribution to the growth expansion in the region. In the cases of Croatia and Montenegro, growth also benefited from good summer 2008 tourism seasons and also, in the former Yugoslav

Republic of Macedonia and Albania, from intensive construction activities. Industrial production in the region remained volatile throughout the region. Given the relatively small size of most countries, the overhaul, closing and re-opening of just a few relatively large production sites considerably affected national average outputs. Overall, metal manufacturing appears so far to be the industrial sector most affected by contracting global demand and collapsing prices, and it has drawn related mining industries in its wake. In Serbia one of the leading exporters closed one plant, whereas the food processing industry continued performing well due to the 2008 good harvest. By contrast, in the former Yugoslav Republic of Macedonia agricultural output remained below overall growth.

As pointed out in the second chapter of this publication, productive investment was not a key driver of growth in the Western Balkans, unlike in the central and eastern European countries that have now become EU Member States. In all countries except Serbia, construction accounts for more than half of gross fixed capital formation (GFCF). Construction is an essential form of almost any investment activity, but higher machinery and equipment acquisitions, in particular with more sophisticated technologies, are also an essential ingredient in order to move towards higher productivity. In recent years, the share of construction has increased in Croatia and Serbia and remained unchanged in the former Yugoslav Republic of Macedonia. In Montenegro investment in hotels and restaurants has been very high as a result of the booming tourism industry, and has proved more resilient to the contraction of external demand than the rest of the real estate sector, which has contracted.

Despite comparable growth levels, the real degree of convergence with the EU differs amongst countries. GDP per capita in the Western Balkans in 2007 represented some 20% of the average EU27 income. However, differences are significant within the group. For instance, Croatia, which is the most advanced in terms of transition reform, enjoys a revenue of about EUR 8,400 per capita, compared with Kosovo's[1] estimated EUR 1,600. The median in the group remains very low, at some EUR 2,600 per capita (Albania, Bosnia and Herzegovina, and the former Yugoslav Republic of Macedonia).

Table I.1.1:

GDP per capita in Purchasing Power Standards (PPS), EU27=100

	2005	2006	2007
Albania	22	23	24
Bosnia and Herzegovina	25	27	29
Croatia	50	52	54
The former Yugoslav Republic of Macedonia	28	29	30
Montenegro	31	35	41
Serbia	32	33	33

Source: IMF, World Economic Outlook

While labour market conditions have improved throughout most of the region in recent years and the first three quarters of 2008, unemployment levels vary greatly. Official unemployment rates continued to decline as employment increased in almost all the countries. However, labour force participation remains very low. In addition, labour market performance shows significant disparities across and within countries. Kosovo, Bosnia and Herzegovina and the former Yugoslav Republic of Macedonia have the highest unemployment rates[2] (respectively 43%, 38.7% and 33.8%) whereas unemployment levels are significantly lower in Croatia (9%) and Montenegro (11.4%). Local differences are significant: in the case of Montenegro unemployment rates range from 5.6% in the Coastal region to 19% in the Northern region. In Bosnia and Herzegovina differences in labour market performance between the two entities continued to widen in 2008.

[1] As defined under UNSCR 1244.
[2] Average unemployment data covering the first half of 2008, except for Kosovo (2007).

Inflation significantly accelerated in the second half of 2007 and the first half of 2008, but slowed after the summer. The acceleration was mainly driven by commodity and oil price increases arising from supply shocks. These were not only related to external factors but also to the regional drought in 2007, which led to considerable increases in the prices of agricultural and food products. Rising prices for crude oil and its derivatives in world markets followed by hikes in administered utility prices (i.e. electricity) also added to higher inflation. Nominal data do not necessarily reflect these common features: year-on-year baseline effects show a contrary trend in Bosnia and Herzegovina, where in 2007 inflation dropped as the effects of the VAT introduction dissipated, and in Serbia, where inflation rose from an average of 6.8% in 2007, to reach 10% by the end of 2008. Based on data for the first nine months of the year, average inflation remained high throughout the region during 2008, fuelled by energy import prices, and possibly second wave price increases. However, most recent indicators point to an easing of prices after July, reflecting last year's high base effect.

Table I.I.2:
Western Balkans countries - Main economic indicators

	Real GDP growth			**Wages** (1)			**Inflation** (CPI) (2)			**Unemployment rate**		
	%			*annual % change*			*%*			*%*		
	2006	2007	2008Q3	2006	2007	2008Q3	2006	2007	2008Q3	2006	2007	2008Q3
Albania	5.5	6.0	n.a.	7.5	17.1	8.8	2.4	2.9	3.0	13.9	13.4	12.6
Bosnia and Herzegovina	6.7	6.8	n.a.	9.6	9.8	16.5	6.1	1.5	9.4	44.2	42.9	40.5
Montenegro	8.6	10.7	8.0	15.6	14.2	24.7	3.0	4.3	9.2	14.7	11.9	10.7*
Serbia	5.6	7.1	4.9	24.4	22.1	17.9	12.7	6.8	10.7*	21.6	18.8	12.5
Kosovo (UN 1244)	3.9	4.4	n.a.	n.a.	n.a.	n.a.	0.6	4.4	9.8	44.9	43.0	n.a
Croatia	4.8	5.6	1.6	6.2	6.2	7.2	3.2	2.9	7.4	11.1	9.6	12.4
The former Yugoslav Republic of Macedonia	4.0	5.9	5.5	8.0	4.8	7.6	3.2	2.3	8.3*	36.0	34.9	33.0
Western Balkans	5.3	6.3	2.6	12.1	12.4	11.9	6.1	4.0	8.5	20.9	19.1	16.2
Memorandum item:												
NMS12	*6.5*	*6.1*	*5.0**	*8.7*	*12.9*	*12.4**	*3.4*	*7.8*	*14.8**	*10.0*	*7.6*	*6.7**
EU27	*3.1*	*2.9*	*1.3**	*2.7*	*3.0*	*3.7**	*2.3*	*4.7*	*8.8**	*8.2*	*7.1*	*7.0**

(1) Gross wages annual growth, (2) Average inflation; RPI in the case of Serbia. * Full 2008 year data.

Sources : national authorities, IMF and European Commission. Data for Kosovo are estimates, which may be subject to significant corrections. Overall, the very uneven quality of data throughout the region mandates cautious interpretations. Significant differences between the various sources and revisions of estimates are frequent.

I.2. REDUCED NOMINAL BUDGET DEFICITS AND DEBT

Overall, the fiscal adjustment which had accompanied positive growth developments and increased price stability in the Western Balkans since 2000/2001 continued until 2006, and in the case of some countries until 2007 (at least in terms of fiscal balances in nominal terms).

Government balances improved until 2006, except in Serbia where the 2006 and 2007 budgets were affected by electoral pressures leading to higher spending on current transfers and subsidies. In 2007, fiscal consolidation was reversed in BiH and Albania as well, and pro-cyclical expansionary policies cancelled out the effect of the still-favourable economic environments on the government balance. Debt levels have come down in the region, in some cases much helped by debt rescheduling by the Paris Club and the London Club creditors (Serbia and Montenegro benefited from a 66% write-off that came fully into effect upon the completion of the IMF programme in 2006), which in the case of Serbia was complemented by early debt pre-payments to the IMF and the World Bank in 2006 and 2007. Estimated fiscal balances and debt levels for 2008 show a mixed picture. There are indicators of a clearly pro-cyclical fiscal stance in Albania and BiH, whereas the strong reduction in Montenegro's budget surplus is reflecting the end of the economic boom. Overall, fiscal revenues held up well in 2008, partly boosted by high rates of inflation as measured by the average annual change of the CPI (except in Albania, where inflation remained moderate).

Table I.1.3:
General government net lending (+) / borrowing (-) (% of GDP)

	2001	2002	2003	2004	2005	2006	2007	Change 01-07
Croatia	-6.5	-4.1	-4.5	-4.3	-4.0	-2.4	-1.6	4.9
The former Yugoslav Republic of Macedonia	-7.1	-5.6	-1.1	0.0	0.2	-0.5	-0.8	6.3
Albania	-8.7	-6.8	-4.9	-5.1	-3.5	-3.3	-4.3	4.4
Bosnia and Herzegovina	-3.3	-0.1	0.7	1.6	2.4	2.9	1.2	4.5
Montenegro *1*	NA	NA	-2.4	-2.6	-2.3	2.7	6.4	8.8
Serbia	-0.5	-3.1	-1.1	0.9	0.9	-1.6	-2.0	-1.5
Kosovo (as defined by UNSCR 1244/1999)	3.3	3.1	2.1	-4.5	-3.0	2.4	6.7	3.4

Table I.1.4:
General government gross debt (% of GDP)

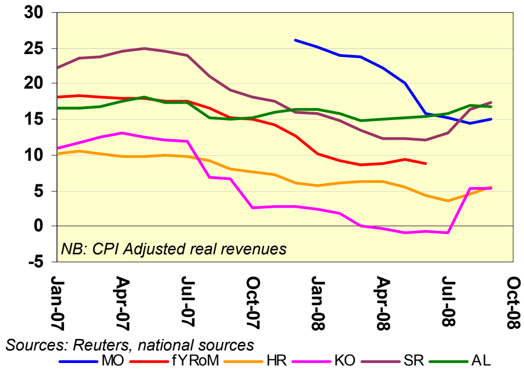
	2001	2002	2003	2004	2005	2006	2007	Change 01-07
Croatia	40.1	40.0	40.9	43.2	43.7	40.8	37.8	-2.3
The former Yugoslav Republic of Macedonia	48.8	43.0	42.9	36.6	39.6	31.6	24.7	-24.1
Albania	67.6	65.3	61.7	56.6	57.4	55.5	53.0	-14.6
Bosnia and Herzegovina	38.1	33.4	37.7	25.5	25.6	21.3	18.5	-19.6
Montenegro *1*	NA	84.5	47.1	44.5	38.6	32.6	26.3	-58.2
Serbia *1*	NA	80.6	64.3	53.3	50.3	36.2	29.4	-51.2

Source: National authorities

In the absence of reliable information concerning cyclical fiscal positions and output gaps – assuming that cyclical adjustment is a relevant measure for catching-up economies – it is difficult to judge how significant the adjustment has been in structural terms since 2001. A first analysis of the composition of fiscal adjustment[1] shows that for the Western Balkan economies as a group the improvement in the fiscal balance can be explained mainly by improvements in revenue collection, whereas lower interest payments have been roughly matched by higher current expenditures. In Serbia, Montenegro, Kosovo and Albania, the adjustment was largely revenue-based, whereas fYRoM and Croatia mostly improved their government balance by reducing current spending.

The structure of fiscal consolidation is therefore a first indicator of potential weaknesses of public finances in the current downturn. If the improvements in revenue collection turn out to have been mostly cyclical, several countries could face a rapid return to their starting positions. This situation could be further aggravated by the fact that the strong acceleration in consumer price inflation which started in July 2007 may have led to a certain degree of illusion influencing fiscal policy makers. The inflationary shock during the 18 months between July 2007 and end of 2008 was amplified by a high dependence on imports combined with a weak capacity of import

Graph I.1.1: **Real revenues monthly y-o-y change in %**



Sources: Reuters, national sources

[1] This analysis was carried out by DG ECFIN (European Commission) using IMF data for the government sector and was published in European Economy, Economic Papers 342, October 2008.

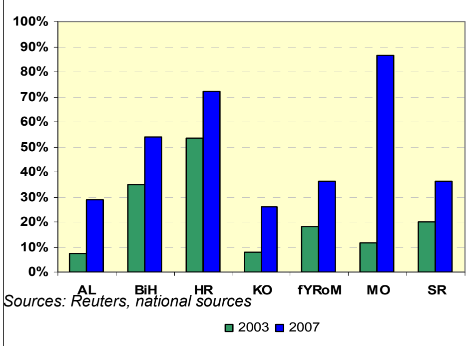
substitution. As a consequence, higher import prices for intermediate goods translated almost directly into a deterioration of the terms of trade and reduced the real disposable income of households. Hence, as consumption and investment decisions reacted with considerable lags, fiscal revenues first increased strongly and continued to display a favourable performance in comparison with budget plans (based on substantially lower inflation rates). However, with the exception of Albania, the growth elasticity of public current revenues decreased in all Western Balkan countries between July 2007 and the end of 2008, indicating a reduced overall buoyancy of tax systems. This development can be illustrated by a simple approximation of real current revenues. Graph I.I.1 shows year-on-year growth rates of monthly current revenues from which we have substracted inflation growth as measured by the year-on-year change in the Consumer Price Index

Looking forward, the fiscal position of the Western Balkan economies may be challenged in 2009 and beyond by the following: i) revenues will be affected further by the shrinking domestic consumption which strongly constrains indirect revenues and the likely decline in economic activity; ii) government treasuries will face higher financing costs, domestically and internationally, for their liquidity and debt management operations, as the dividend of the recent episode of falling interest tax rates will disappear and higher financing costs could easily eat up dividends earned in the period under review (roughly since 2000); iii) policy makers will face political pressure to protect social transfer and public wage budgets to the detriment of public capital expenditure (and past experience has shown that such pressure is difficult to resist), and the quality of public spending could rapidly deteriorate as a result.

I.3. GROWTH WAS INCREASINGLY FINANCED BY BOOMING CREDIT

Rapid credit growth has been one of the main drivers of growth in the region in recent years as it has boosted both domestic consumption and investment. Albeit starting from low levels relative to GDP, domestic credit growth has been firmly in double-digit territory in the Western Balkan economies in the past five years. As a result of this rapid financial deepening, the ratio of domestic credit to GDP has reached relatively high levels in Montenegro, Croatia and Bosnia and Herzegovina. The growth trend was maintained also in 2008, despite the financial turmoil which started to affect the international capital markets in late 2007.

Graph I.I.2: **Domestic credit (as a % of GDP)**

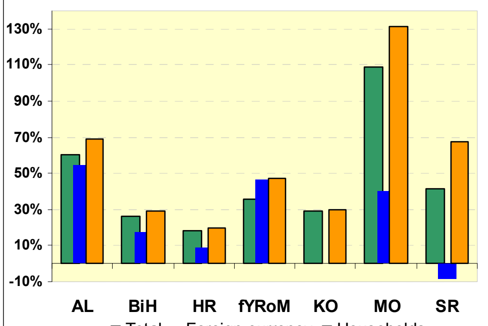


Sources: Reuters, national sources

Two important factors shaped this process of rapid financial deepening. On the one hand, the banking and non-banking financial sectors were restructured and largely placed in the ownership of reputable foreign financial institutions as part of a comprehensive privatisation agenda. This has improved financial and risk management skills and increased the degree of product sophistication in the sector. On the other hand, until 2008 access to international capital markets improved significantly, partly as a result of the global monetary easing leading to the availability of ample liquidity and partly due to the increased creditworthiness of the reformed financial institutions. In addition, the regulatory and supervisory capacities of the authorities were significantly strengthened in most of the economies, although concerns about the independence of supervisors and the implementation of the improved regulations remain.

Domestic credit has grown very fast, in particular in Montenegro and Albania where the annual growth rates were in excess of 100% and 60% respectively on average over 2005-2007. In all the economies, the growth of credit was driven by the private sector component and in particular by household lending. Credit to households expanded by more than 130% on annual average in Montenegro and close to 70% in Albania and Serbia. This suggests that the allocation of credit was in many cases biased towards consumption rather than productive or investment activities. The consumption-smoothing process was facilitated both by higher-income prospects and the relatively favourable lending conditions. The corporate sector remains predominant in the existing total stock of credit, but its share has gradually declined: it was down to only about 44% in Croatia and 55% in the former Yugoslav Republic of Macedonia in the second half of 2008. This trend not only weakens the economy's long-run growth capacity, but also increases repayment risks as the increased competition for market shares among banks, especially in the retail segment, puts pressure on the quality of their loan portfolios (see chart I.I.4).

Graph I.I.3: **Domestic credit (avg. annual growth 2005-2007)**

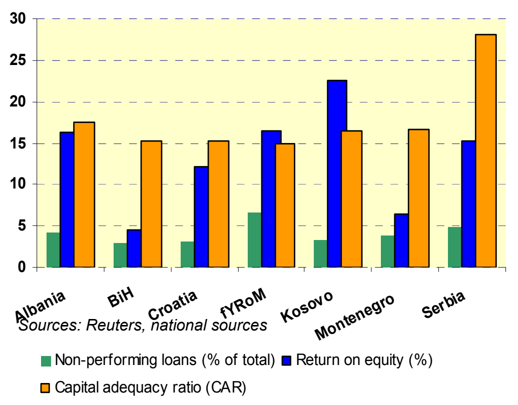


Sources: Reuters, national sources

The rapid credit growth also took place in a context of widespread lending in foreign currency or indexed to foreign currency, which grew very fast in particular in Albania and the former Yugoslav Republic of Macedonia. Lending in foreign currency was favoured by the actual or de facto pegs used by a number of countries in the region. This exposes banking systems to exchange rate risks. Even though, in general, banks are well hedged against foreign exchange risk and their net open positions in foreign currency are limited, their clients – in particular, households – are in general not hedged. In addition to the boom in domestic credit, lending from abroad started to flow directly into the non-bank – especially corporate – sector. In many cases, the more dynamic cross-border borrowing represented a response to internal restrictions, including high reserve requirements or credit ceilings aimed at capping credit growth or redirecting lending into domestic currency. As a result, the balance sheets of domestic credit institutions now only partially reflect the outstanding foreign currency assets and the risks assumed in the economy, which complicates policy making and adds to macroeconomic risks.

The banking systems' prudential indicators improved in recent years, as a result of both reforms in the banking sectors and the fast-growing stocks of assets, which depressed non-performing-loan ratios. Bank capitalisation was still solid throughout the region with an adequacy ratio of around 17.5% at the end of September 2008, well above the Basel benchmarks. However, in some countries, such as Montenegro and the former Yugoslav Republic of Macedonia, the ratio has decreased relatively rapidly due to the rising lending activities in recent years. Differences in the ratios of non-performing loans to total loans are fairly high from one country to another, ranging from around 3% in Bosnia and Herzegovina to 6.6% in the former Yugoslav Republic of Macedonia at the end of September 2008. The average profitability of the banking systems has reached comfortable levels in most of the economies in question. Overall, the radical transformation of the Western Balkans' banking systems during transition has made them more

Graph I.I.4: **Bank Prudential Indicators (2008 Q3)**



Sources: Reuters, national sources

resilient and put them in a better position to absorb domestic and external shocks. Nonetheless, the very rapid credit growth witnessed in recent years has enhanced risks especially as the region has experienced banking crises in the past, which may make depositors more cautious.

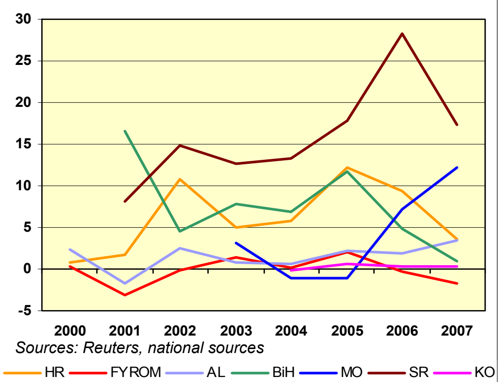
I.4. HIGH CURRENT ACCOUNT DEFICITS EASILY FINANCED FROM FDI AND PRIVATE LENDING INFLOWS

As growth accelerated in recent years throughout the region, trade deficits – boosted by commodity and energy price increases in 2007-2008 – and external imbalances widened, financed mainly by remittances, foreign private lending and foreign direct investment (FDI).

Following the stabilisation of the region from late 2000 onwards, and the prospect of EU accession being extended to all Western Balkan countries at the June 2000 Feira European Council, foreign investors became increasingly interested in the Western Balkan region. Local entrepreneurs and foreign companies seized the opportunity to start up local business. As existing machinery and equipment was largely obsolete there was a strong need to upgrade the capital stock by importing modern technology. In addition, the previously repressed consumption of households resulted in a strong increase in the demand for durables and other goods, which could not be fully satisfied by local production.

These developments within the real economy are the underlying elements determining the balance-of-payments trends in the Western Balkan since the start of transition. At the same time, market-oriented banking systems were established throughout the region, mostly with the help of capital from EU-based banks. This gave households and the corporate sector increasingly access to foreign financing. As domestic savings remained substantially below investment demand, the opening up of access to foreign financing resulted in substantial capital inflows to the whole region.

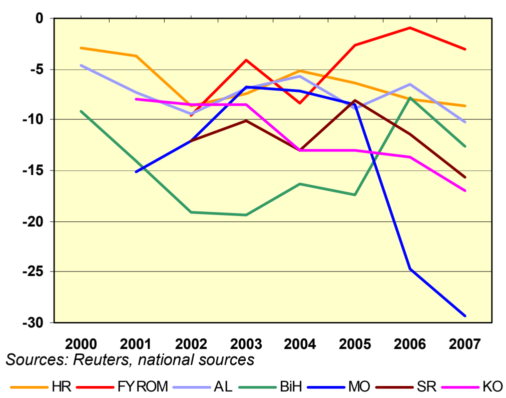
Graph I.1.5: **Net Foreign Lending in % of GDP**



Sources: Reuters, national sources

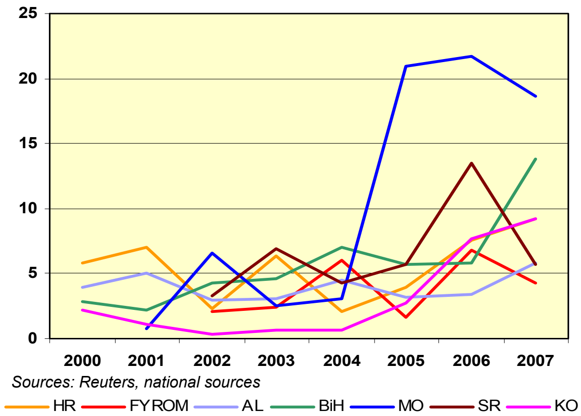
As a result of the high demand for consumer and investment goods since the start of transition, combined with growing availability of foreign savings, relatively large current account deficits were recorded throughout the region, and increased towards the end of the period in 2007 and the first half of 2008. Montenegro witnessed a significant increase of the deficit in 2006 and 2007, coinciding with booming foreign direct investment, primarily directed towards the local real estate sector. All other countries have experienced an increase in the current account deficit in the year 2007, reflecting the acceleration of economic activity during that year.

Graph I.1.6: **CAD in % of GDP**



Sources: Reuters, national sources

Graph I.1.7: **Net FDI in % of GDP**

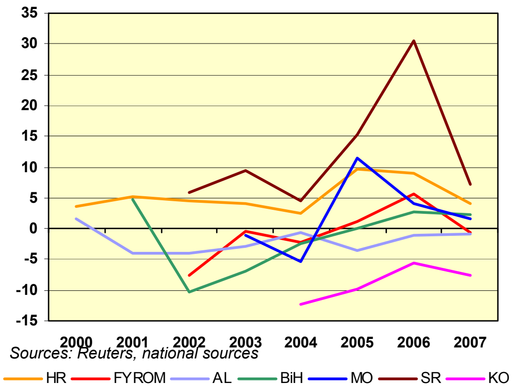


Sources: Reuters, national sources

Foreign direct investment and foreign loans were biased toward the non-tradable sector and consumption rather than investment, and thus had no significant impact on productivity growth and the creation of a strong export base (see second chapter on investment dynamics in this publication). However, the structure of capital inflows improved from 2003 to 2007 as the share of foreign direct investment in capital inflows increased. This occurred as large privatisation deals were completed successfully and greenfield investments started – however modestly – to develop in some countries.

Due to the strong inflow of foreign direct investment and foreign loans, most countries in the region experienced higher financial account surpluses than current account deficits, in particular during the period between 2005 and 2007, resulting in a substantial accumulation of financial reserves. This was particularly the case for Croatia and Serbia, leading to a build-up of substantial foreign exchange reserves (5.0 and 5.9 months of imports respectively by the end of 2008). The exceptions were Albania and Kosovo, which recorded higher current account deficits than capital account surpluses. However, it is worth noting that these two countries experienced a particularly strong inflow of remittances, which were not fully recorded in the current account.

Graph I.1.8: **Net Foreign Reserve Accumulation in % of GDP**



Sources: Reuters, national sources

As a consequence of the crisis, economic activity within the region peaked end-2007 / early 2008 and started to decelerate in 2008. As a result, demand for imported goods began to decline. As imports are slowing faster than exports, current account deficits are already in the process of a substantial downward adjustment, reflecting changes in global demand and supply conditions for goods and real savings.

I.5. STRUCTURAL REFORMS CONTINUED AT AN UNEVEN PACE

Fiscal reforms were continued, with most countries improving their tax collection and public investment procedures. Albania introduced a flat income tax rate of 10% for individuals in mid-2007, and for the corporate sector as from January 2008. This appears to have resulted in a broadening of the tax base, suggesting virtuous Laffer curve effects. The Federation of Bosnia and Herzegovina adopted a reform of direct taxation. Montenegro continued reducing taxation and introducing flat rates. It further consolidated public expenditure by integrating extra-budgetary funds within the treasury system and extending the coverage of investment projects under the capital budget. Croatia enhanced its analytical capacity for setting up medium-term fiscal frameworks and improved its budget planning capacity and procedures, with wider recourse to fiscal impact assessments. Also, the former Yugoslav

Republic of Macedonia continued to improve the efficiency of tax administration and to simplify the tax system. However, the quality of its public finances remained impaired by weaknesses in medium-term budget planning and priority-setting, leading to a high share of discretionary and short-term oriented spending decisions.

A number of positive developments took place with measures aimed at facilitating market entry and exit mechanisms as well as improving the business environment being introduced. In Albania the government launched more efficient business registration procedures introducing "one-stop-shops" and abolishing a number of licensing requirements. This resulted in improved company registration procedures. However, remaining administrative inefficiencies continue to hamper market entry and exit. In Bosnia and Herzegovina, company registration and licensing procedures have improved marginally, with the courts implementing a new company registration system, but significant administrative inefficiencies continue to hamper market entry and exit. In Montenegro, the creation of new firms is being facilitated by a reduction in red tape. Yet, further progress on the granting of business licences is still needed. In Serbia, bankruptcy procedures have been slow due to a lack of qualified administrators and delays in commercial courts. Excessive bureaucratic requirements and complex legislation are continuing to hamper market entry and exit. In Kosovo, limited access to finance, red tape and legal uncertainty (in particular as regards property ownership) continue to weigh on market entry. To improve the overall business environment, and in particular company registration, Croatia launched a project to reduce the burden of unnecessary legislation. The former Yugoslav Republic of Macedonia continued to lower entry barriers and to speed up registration and exit procedures, amending the laws on the one-stop shop, the trade registry and the registry of other legal entities. Moreover, the backlog in bankruptcy cases has been reduced.

Table I.1.5:

World Bank - Doing Business Survey (2009, global risks (1))

	Croatia	TfYR Macedonia	Albania	Bosnia and Herzegovina	Montenegro	Serbia	*simple average WB*
Ease of Doing Business	**106**	**71**	**86**	**119**	**90**	**94**	***94***
Starting a Business	117	12	67	161	105	106	*95*
Dealing with construction permits	163	152	170	137	167	171	*160*
Employing Workers	146	125	108	117	104	91	*115*
Registering Property	109	88	62	144	123	97	*104*
Getting Credit	68	43	12	59	43	28	*42*
Protecting Investors	126	88	14	88	24	70	*68*
Paying Taxes	33	27	143	154	139	126	*104*
Trading Across Borders	97	64	77	55	125	62	*80*
Enforcing Contracts	44	70	89	123	130	96	*92*
Closing a Business	79	129	181	60	42	99	*98*

(1) from 1 (best performer) to 181 (worst performer)

Source: The rankings are from the Doing Business 2009 report, covering the period April 2007 to June 2008.

Restructuring and privatisation progressed unevenly. The absence of a larger private sector share is an obstacle to developing competitive domestic products and services, and risks affecting adversely inflation and external accounts. In addition, unsustainable loss-making public companies continue to be a burden and a contingent liability for public finances. In Albania the privatisation of large-scale companies advanced in 2007, notably in the telecommunications sector. In Bosnia and Herzegovina the privatisation process in the different constituent entities was uneven, with more rapid progress in the Republika Srspka, which has also initiated bankruptcy procedures in more than 100 socially-owned enterprises (SOE). In Montenegro the privatisation process resumed vigorously after the adoption of the new constitution in autumn 2007 and restructuring activities are at present focused on major utilities. While privatisation also continued in Serbia, there is still no clear strategy for the privatisation of state-owned companies and state intervention in the enterprise sector remains substantial. In Kosovo the privatisation of socially-owned enterprises continued in 2007, but was interrupted in 2008 after a court ruling raised doubts on the legality of the privatisation process managed by the Kosovo Trust Agency (KTA). The restructuring of KEK, the incumbent electricity utility, remains a priority given the unsustainable financial situation of the company and the frequency of electricity cuts negatively affecting economic activity. Croatia continued with the restructuring and unbundling of the railways. However, the restructuring and privatisation of its large shipbuilding sector, which still benefits from considerable state aid, has made only limited progress.

Banking supervision was strengthened in a number of countries. In Albania a comprehensive overhaul has strengthened the regulatory framework for banking supervision, thereby continuing the process of alignment with international practice. In Bosnia and Herzegovina the two entities worked individually on strengthening banking supervision and expanding it to new areas in the financial sector and a Memorandum of Understanding between the two Banking Agencies and the Central Bank was signed in June 2008. Montenegro adopted a new banking law approximating its legislation to Basel II core principles. In Serbia, privatisation of the remaining state-owned banks is well under way and competition between banks is well established. In Kosovo financial intermediation continues to suffer from high interest rate spreads, costly collateral registration, deficient cadastral procedures and weak credit information procedures. The Croatian banking system still has to cope with foreign-exchange induced credit risks arising from un-hedged balances in the non-financial sector. Yet the largely privately-owned banking sector has remained generally sound amid a rapid credit expansion, while prudential regulation has led to a stronger recapitalisation of banks, which has been conducive to financial sector stability in general. The financial sector in the former Yugoslav Republic of Macedonia remains small, but significant progress has been made in deepening financial intermediation, increasing competition on the financial market and strengthening the legal framework and supervision of the sector.

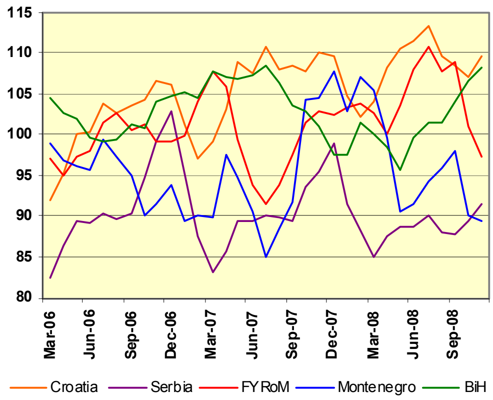
Further progress has been made in reforming social security systems in the region. In Bosnia and Herzegovina, after some preliminary parametric reforms, the authorities are considering the introduction of additional pillars based on the capitalisation of contributions to the current pay-as-you-go pension systems. Montenegro adopted in 2007 a regulation introducing voluntary pension insurance. In Serbia, a number of by-laws on voluntary pension funds and pension schemes have been passed. In Croatia the government adopted a social welfare reform to streamline numerous benefits and better target social assistance. Initial reforms of the financing of health care, which were adopted in mid-2006, have so far not been complemented by more ambitious steps to fully address the sector's financial difficulties. Pension funds in the former Yugoslav Republic of Macedonia must now comply with stringent restrictions and requirements regarding the type and volume of domestic securities that they can purchase on the stock exchange.

Overall, while improvements in the business environment and deeper financial sectors have made the region more resilient to adverse external developments, the reform agenda remains large and there remain considerable challenges ahead. The large informal sector suggests that rigidities remain in labour markets. The judiciary remains largely unable to ensure the rule of law in key areas such as contract enforcement and enterprise liquidation. Weak administrative capacities limit the speed of reforms, the delivery of basic public services and the absorption capacities for public investment in the area of much-needed infrastructure. Large shares of the public sector, notably public utilities, still need modernisation and privatisation. In view of the important savings gap the banking sector relies heavily on external sources of finance to pursue its deepening and modernisation, which in the present context appears to be a source of vulnerability. And financial markets are still in their infancy.

I.6. THE IMPACT OF THE GLOBAL INTERNATIONAL CRISIS IN THE REGION

I.6.1. First signs in the real economy indicate that the crisis is unfolding at a variable pace in the different countries

Graph I.1.9: **Industrial Production 3mma**



Sources: Reuters, national sources

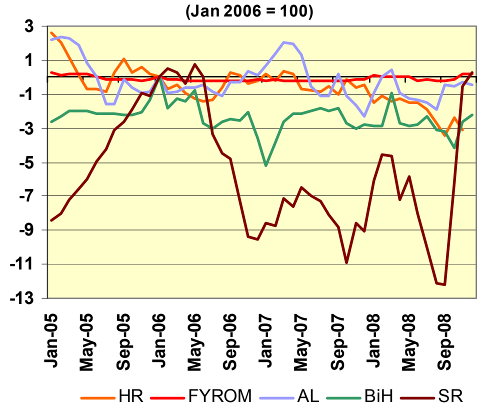
There are clear indications that the global financial crisis and the growth slowdown in the world economy and in particular in the region's main EU trading partners have started to affect the economies of the Western Balkans, particularly from the third quarter of 2008 onwards. Economic activity has begun to decelerate, although the degree of slowdown varies. GDP growth came down markedly in the third quarter due to weaker external and domestic demand and high-frequency indicators clearly suggest a further deterioration of economic performance in the fourth quarter of 2008 in some countries. It appears that the countries' different level and structure of international trade and investment integration partly explains how the crisis has impacted on their recent growth performance. Countries which have strong trade and investment links with the EU were affected earlier and the effect has been more pronounced. Those countries which are less integrated with the EU seem to have been more resilient so far, such as Albania or Bosnia and Herzegovina. However, the effects of the crisis are likely to be felt across all sectors in the region, though with lagged effects, as real adjustments of lending and consumption levels will have to take place.

In most countries, FDI inflows continued to be strong throughout 2008. However, Bosnia and Herzegovina, where FDI inflows more than halved in 2008, and Kosovo, where the privatisation process was interrupted in 2008, are negative outliers. In the case of Bosnia and Herzegovina this was mainly the result of a base effect as 2007 was an exceptional year when FDI was linked to a number of large privatisation deals. In Serbia and Croatia, FDI inflows also slightly decreased, while in Albania, fYRoM and Montenegro they were still on the rise. It can be expected that foreign investors will be more hesitant to invest in the countries of the region as the crisis progresses. However, FDI flows still depend to a large extent on the ongoing privatisation process, and one or a few successful privatisations can already be decisive for FDI development as a whole, especially in the smaller economies.

Revenues from remittances have been an important source of income and external financing for a number of countries in the region. In 2007, remittances from abroad accounted for around 3% of GDP in the case of Croatia and around 10% of GDP in Albania and Serbia. The countries where remittances are most significant are Bosnia and Herzegovina and the former Yugoslav Republic of Macedonia, where they represent around 16%–17% of GDP, as well as Kosovo, though the data there are less reliable. Available data and anecdotal evidence suggest that the crisis has only mildly affected inflows from remittances so far. However, the growth slowdown in some major European economies (notably Germany and Italy) is having a lagged effect for the Western Balkans. Expected changes in employment levels and unemployment rates in host countries are likely to sooner or later affect the volume of remittances to home countries, although remittances tend to be less volatile and more resilient to economic downturns in host countries than private capital flows.

Some countries have experienced tensions in the foreign exchange markets. Serbia and Albania are the only countries in the region that have a more flexible exchange rate regime. Both have announced that monetary policy would move towards inflation targeting. However, market reactions have been quite different in those two countries. The Serbian dinar has come under increasing pressure since the beginning of October, losing close to 17% vis-à-vis the euro during the fourth quarter 2008, and continuing to decline in January 2009. This led to the National Bank of Serbia taking a number of policy steps and intervening repeatedly in the interbank foreign exchange market. As a result, official foreign exchange reserves declined by some 8½% (EUR 800 million) since the beginning of October to EUR 8 billion at end-2008 and slightly increased again by the end of February 2009. These central bank interventions on the foreign exchange market have postponed – and may render more difficult – the move towards a credible inflation-targeting regime. In contrast to the Serbian dinar, the Albanian lek remained relatively stable vis-à-vis the euro in the fourth quarter of 2008, but depreciated by 7% in the first quarter 2009.

Graph I.1.10: **Nominal Exchange rates, (Jan 2006 = 100)**



Sources: Reuters, national sources

The increased credibility of monetary policy that central banks of the region have been able to build up in recent years and their ability to react to shocks has been an asset in the recent crisis environment. However those gains are not irreversible. 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. Nevertheless, between the third quarter of 2008 and March 2009 the Croatian kuna depreciated by 4% vis-à-vis the euro and the central bank had to intervene regularly by selling euros in the market. Bosnia and Herzegovina, for its part, has a euro-based currency board arrangement. However, the volatility of spot rates around the fixed rate of 1.95583 BAM/EUR increased significantly during the month of October when tensions in the financial market led to a withdrawal of deposits by the population and liquidity shortages in the banking system. Finally, the use of the euro as legal tender in Montenegro and Kosovo has protected those states from any exchange rate instability. Product and factor markets in these countries will have to deliver adjustments that in other economies are avoided by allowing the exchange rates to depreciate. Overall, it appears that exchange rate regimes in the region have so far broadly contributed to stability.

I.6.2. The financial channel of transmission of the crisis.

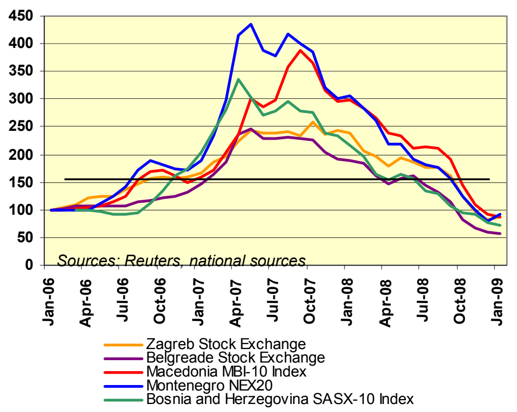
The Western Balkans have started to feel the impact of the crisis through the trade and financial transmission channels. As shown above, the countries of the region have over the past few years benefited from relatively easy access to external financing, while domestic savings rates were low. Surges in net capital inflows helped finance savings-investment gaps in those economies as evidenced by large and in some cases increasing current account deficits. Capital imports consisted to a large extent of lending from abroad fuelling high domestic consumption. With tightening credit conditions on international capital markets and a re-pricing of risk, it is obvious that foreign savings will not continue supporting this growth model at the same level as before. Some degree of adjustment will have to take place, as these countries will not be able to find external financing at the amount and cost required to maintain their recent growth path.

The risk of an immediate liquidity crisis currently appears to be limited as available short-term foreign exchange assets seem to be sufficient to cover short-term financing needs. At the end of 2008 official reserves covered between 3.6 months of imports in the former Yugoslav Republic of Macedonia (though only 2½ in Montenegro and Kosovo – but these are both fully euroised) and 5.9 months in Serbia. However, there remains a high degree of uncertainty, especially regarding the private sector's assets and ability to roll over debt, both in the corporate sector and households.

Tighter external financing constraints and domestic liquidity conditions have had an impact on domestic interest rates in the region and those effects are expected to become more pronounced over the short term. Borrowing costs have increased in some countries, particularly in Serbia where the average interest rate on loans to the private sector jumped from 10.8% in December 2007 to 17% one year later, and to a lesser extent in Croatia, putting a brake on domestic consumption and investment.

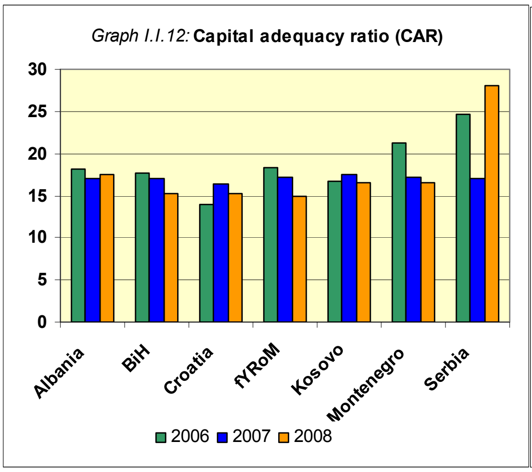
Spreads on corporate and government borrowing have increased significantly. On Serbian debt, they increased by 100 bps to 8% between September and October 2008, but 5-year credit-default swap (CDS) spreads on government securities have remained relatively stable at 250 bps. In the case of Croatia, spreads on 10-year-government bonds over euro-bonds have markedly increased to 350 basis points in December, which was however a combined effect of higher borrowing costs and a significant lowering of Eurobond yields in the second half of 2008. Higher borrowing costs will increase outflows and thus put additional pressures on the external side, as already observed in a number of countries. Moreover, public finances are likely to have to bear such higher debt service burdens.

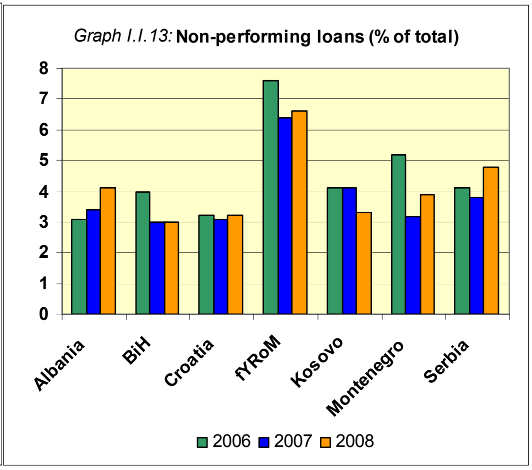
Graph I.I.11: **Stock exchange developments**

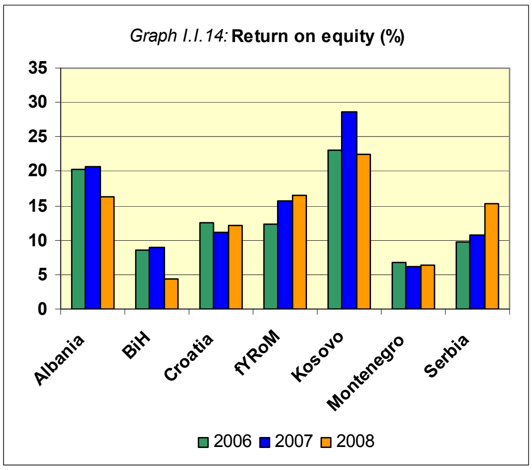


Stock market prices have shrunk throughout the region, and in some cases the decline in stock markets has been more pronounced as compared to developments outside the region. Since their respective peaks in 2007, stock markets indexes lost close to 80% in Serbia, Montenegro, Bosnia and Herzegovina and the former Yugoslav Republic of Macedonia, and around 68% in Croatia. Significant falls in asset prices and the related wealth and income effects are likely to trigger second round effects as the corporate sector and private households adjust their spending decisions. Other asset prices, and in particular of real-estate, will continue to tumble, but it may take a while until prices reach the new equilibrium. Excess inventory and foreclosures are likely to put additional downward pressure on real estate prices, thus further weakening the assets side of the banking sector. During this period of price adjustment, residential and commercial real-estate construction will most likely remain subdued.

Banking sectors in most countries seem to be resilient, with relative high profitability and a sound capital base. However, foreign re-financing of domestic banks has reportedly become more expensive, but they have so far been able to roll over debt. The sector is benefiting from earlier bank recapitalisations which were driven by adjustments in prudential regulations and supervisory standards. Croatia is a good example of this. If the domestic financial sector has not been the generator of a financial crisis so far, it is nonetheless exposed to the negative feed-back loop from the real economy crisis. A recession in many economies of the region implying reduced economic activity, company bankruptcies and lay-offs of staff could put pressure on the repayment capacity of debtors, non-performing loan levels and the capital/liquidity of the banking systems. Higher cost of capital and external refinancing constraints will probably feed into a deleveraging process, which however is likely to be more subdued than in other economies given the relatively good capitalisation of banks in the region.







Sources: Reuters, national sources

The region's non-financial corporate sector has in recent years benefited from significant cross-border lending, in some cases resulting from domestic restrictions on credit growth and banks' foreign borrowing. The private enterprise sector has accumulated larger external liabilities particularly in Croatia and Serbia, with some share of the outstanding external debt falling due over the short term. This increases vulnerability to an aggravation of external financing constraints that would put additional pressure on declining domestic and external demand conditions.

I.6.3. The authorities' first set of measures in response to the crisis

The governmental and monetary authorities have since mid-2008 taken a number of measures in response to the global financial crisis. Central banks have tried to improve the liquidity of financial systems by lowering minimum reserve rates and by injecting cash into the system. A number of governments included additional measures in their budget proposals, with the aim of both improving confidence in the banking system and strengthening domestic demand and supporting troubled industries.

The Croatian central bank lifted the marginal reserve requirement for banks' foreign borrowing and reduced the minimum reserve on domestic deposits in order to boost liquidity. Also, the deposit insurance law was amended by Parliament, leading to a fourfold increase of the guaranteed amount of household deposits (to € 56,000). In the former Yugoslav Republic of Macedonia, the government presented a 10-measure crisis response package at the end of November, to the tune, it claimed, of 5-

6% of GDP. The majority of the measures (amounting to some 3-4% of GDP) consist of tax rebates and write-offs of unpaid social security contributions. The remaining part (about 2% of GDP) consists of a further lowering of taxes on profits and agricultural incomes. The authorities intend to finance this package through international loans and a Eurobond issue.

In October, the Serbian central bank increased its key policy rate by 200 basis points to 17.75% to support the local currency which had come under pressure, depreciating by about 23% vis-à-vis the euro since the end of September 2008. In addition, the central bank has increased the amount of guaranteed deposits, lifted reserve requirements for banks' foreign borrowing and eliminated the tax on savings income to help boost foreign exchange liquidity on the local market. It also repeatedly intervened in the interbank foreign exchange market to smooth the depreciation of the dinar and to boost foreign currency liquidity. In this context foreign exchange reserves at the NBS declined by some EUR 1.5 billion since end-September to EUR 8.1 billion at end-2008. In November the Serbian authorities agreed a 15-month precautionary Stand-By Agreement with the IMF, allowing Serbia to draw up to € 415 million from the Fund if needed. At the end of December the Serbian parliament adopted a 2009 budget, in line with the IMF programme, aimed at reducing the general government deficit to 1.8% of GDP from 2.3% in 2008. On 29 January the government adopted a set of measures intended to offset the effects of the global economic crisis on the country, including soft loans and guarantees. The objective is to inject liquidity in the economy, finance investment and stimulate consumption of domestically produced goods. In addition drawings from international financial institutions will finance SMEs.

Summary box: Main measures in response to the global financial crisis

	Central Bank	Government/Parliament/…	Fiscal size (% of GDP)
AL	- Introduction of restrictions on capital movement - Preparation of new law on financial collaterals	- The 2009 budget foresees an amount of 1.3% of GDP for reserves and contingency.	1¼% of GDP
BH	- Cash to banking system - Lowering of minimum reserve requirement from 18% to 14% and to 10% for deposits with a maturity of more than one year	- Increase in deposit insurance from € 3,500 to more than € 10,000 - New fluctuation bands on stock exchange	
HR	- Lifting of marginal reserve requirement of foreign borrowing. - Lowering marginal reserve for domestic deposits	- Quadrupling of deposit insurance to € 56,000 - March 2009: budget rebalancing.	
KO*	- Introducing a maximum level of 20% of total assets that banks can be exposed to their mother companies. - Setting up of a crisis management team and conducting full non-regular on-site examinations of the two major banks.	- The 2009 budget includes a € 200m "stabilisation reserve". - Preparation of a deposit insurance law foreseeing a maximum guaranteed amount of €2.000.	
MK**		- Amnesty on unpaid taxes and social security contributions and accrued interest for payment arrears - Reduction of tax on profit and agricultural incomes - Lowering import tariffs - April-May 2009: budget rebalancing	3-4 % of GDP 2% of GDP 0.05 % of GDP
MN	- Full guarantee of deposits - Improving banking sector liquidity by providing state guarantees, loans and recapitalisation support		10% of GDP
	- Increase of capital adequacy ratio from 8% to 10%	- Increase in capital expenditure - Early debt redemptions - Lowering social contributions and taxes - Subsidies to compensate increases in electricity prices	
RS	- Increase of key policy rates by 200 basis points to 17.75% and frequent market interventions to stem the depreciation of the currency. - Increase of deposit guarantee, lifting of reserve requirement for bank's foreign borrowing, - Elimination of tax on savings deposits - Adoption of measures to boost domestic demand through the extension of soft-loans.	- 15-month USD 415 million pre-cautionary stand-by arrangement with IMF - Budget rebalancing expected following IMF staff mission end-March 2009	3% of GDP

* *as defined by UNSCR 1244*

*** The former Yugoslav Republic of Macedonia's provisional code which does not prejudge in any way the definitive nomenclature for this country, which will be agreed following the conclusion of negotiations currently taking place at the United Nations.*

The Albanian central bank restricted capital placements by banks with their parent banks abroad, and announced the preparation of a new law on financial collateral arrangements. With the aim of safeguarding the liquidity of the banking system and stimulating credit activities, the central bank of Bosnia and Herzegovina lowered the minimum reserve requirement rate from 18% to 14% in October. Furthermore, as of November all new credit lines withdrawn from abroad by commercial banks do not enter into the basis for the calculation of required reserves and, as of January 2009, the required reserve rate on term deposits with a remaining maturity of more than one year has been lowered to 10% while it remains at 14% for deposits with a maturity of below one year. In the meantime, the government initiated an increase of the deposit guarantee from around EUR 3,500 to more than EUR 10,000. The Sarajevo Stock Exchange introduced new fluctuation bands on the prices of traded securities. In mid-November, the government of the Republika Srpska set up a new body to monitor the impact of the global crisis and to propose measures for alleviating its negative domestic repercussions.

In mid-September, the Central Bank of Montenegro raised the required capital adequacy ratio for the banking sector from 8% to 10%, with effect from 1 March 2009. In mid-October, the government adopted a series of pre-emptive measures in order to respond to the negative impact of the global financial crisis. In response to the slowdown it planned a significant increase in capital expenditures. It will also try to alleviate the negative repercussions of the global crisis on the local economy by earlier debt redemptions, and a decrease of social contributions and taxes. In addition, the authorities will continue providing support for the liquidity of banks, by using credits, backing guarantees and potential recapitalisation. The authorities also adopted a programme of subsidies for electricity after the regulatory agency increased prices in December. Overall, the entire government stimulus package is estimated at some 10% of the projected GDP for 2009.

The Central Bank of Kosovo established a contingency plan. Banks' reporting requirements were tightened and local institutions were asked to gradually decrease their exposure to foreign parent banks to 20% of Tier I capital. There has been an increase in the exchange of information with central banks and other supervisory authorities as well as with the boards of key players in the banking sector (RZB, ProCredit and NLB).

I.6.4. Main policy challenges

It will be quite a challenge for the Western Balkan authorities to design adequate policy responses to the financial and economic crisis. Significant constraints in both the monetary and fiscal spheres leave only limited scope for active policy responses. The burden of adjustment may therefore fall on domestic demand and relative prices in most countries. Accelerating structural reforms in labour and product markets may help this adjustment.

The monetary policy response is limited by the frequent use of the exchange rate as a nominal anchor and high degree of euroisation affecting both the financial and non-financial sectors. The widespread use of the euro as a financial currency (for transactions, lending and savings) has further reduced the scope for an "independent" monetary policy. Close to 75% of the stock of domestic credit is either denominated in or indexed to the euro while the share of bank deposits denominated in euro stands at around 60% of the total in the region. Financial developments during the past decade show that it is difficult to reverse this systemic feature which to some extent stems from the legacy of hyperinflation in the 1990s.

Central banks continue to make use of instruments such as reserve requirements, remuneration of reserves, or prudential and administrative measures that influence the volume and quality of lending, but more consistent adjustments of the money supply in the short run through normal interest rates instruments are prevented by the monetary frameworks in place. Monetary authorities in the countries with less rigid pegs could be in a better position to accommodate shocks induced externally to the money supply, such as reduced inflows or potential capital outflows that could be triggered by the crisis. But even in these countries, the room for manoeuvre of monetary policy transmission mechanisms is limited by widespread euroisation.

The option of a fiscal policy stimulus varies from country to country and depends first and foremost on the available fiscal room for manoeuvre. While this may not look as the main problem given the decline in public debt to relatively moderate levels in most economies in recent years, external financing constraints and the likely deterioration in the fiscal outlook for 2009 and 2010 have created a new challenge for fiscal policy. All the Western Balkan economies are burdened by significant external imbalances and current account deficits. Although expected to decline, these will probably remain relatively high also in 2009. The fiscal consolidation witnessed in recent years was mainly the result of tax-rich growth patterns in particular in Montenegro, Serbia, Kosovo and Albania, rather than of an adjustment on the spending side of the budgets. As a matter of fact, spending levels relative to GDP have recently increased in some countries, notably Montenegro, Serbia and Bosnia and Herzegovina. This, combined with the likelihood of shrinking revenue, makes the risks surrounding budget execution in 2009 and 2010 fairly high. As a result, public spending needs to be very carefully calibrated in order to avoid crowding out the private sector's access to domestic and external savings.

In general, the fiscal policy stance influences greatly the behaviour of investors and consumers. If prudent fiscal policies are pursued in the region, they are likely to instil confidence in the markets and thus contribute to a recovery. Another challenge is the need to design a fiscal policy response which takes into account the growth patterns prevailing in recent years. The large-scale use of external savings by the private sector which fuelled an economic boom in particular in consumption and the non-tradeable sectors is now entering an adjustment phase which will need to lead to a more sustainable growth path in the future. The fiscal response needs to allow corrective mechanisms to work in order to generate higher domestic savings rates and to better allocate resources, particularly where insufficiently reformed public sectors still account for a large share of the economy.

In view of the above, it appears that while limited adjustments may be achieved through the monetary and fiscal instruments, the policy response also – and possibly in some cases mainly – needs to focus on strengthening the flexibility of labour and product markets, so that prices are allowed to adjust more freely. The international financial crisis, which implies external financing constraints and a retreat from risky assets, is increasing the volatility of the domestic and foreign exchange money supply. If wages and product prices respond properly to downward moves in the money supply, purchasing power should be partially restored and should not therefore hamper production or economic recovery. A global higher cost of capital is likely to lead to a reallocation of production capacities to locations where labour is cheaper. Allowing for euro wages and the non-wage cost of employment to adjust would help limit output losses resulting from such a trend in the region. Furthermore, accelerating structural reforms and upgrading the skills of the labour force would facilitate the continuation of investment inflows in the recovery phase while improving the allocation of financial and human capital to productive and export-oriented activities.

Concluding remarks

The shock waves of the international crisis reached candidate and potential candidate countries in the second half of 2008 and early 2009. However, the fallout on economic activity and policy response was quite uneven across the region. Overall countries with a high degree of financial and economic integration have already started to suffer from the global risk aversion and liquidity shortage as well as from the slowdown of economic activity in the EU. This is clearly the case for Croatia and Serbia. A second group of countries that is less integrated into the international value added chain has remained relatively shielded so far – as this chapter is being written – but will most likely not remain immune, not least because all these economies displayed considerable external imbalances until 2008.

The current accounts of the Western Balkans are at present facing a mix of negative (real) shocks stemming from a massive slowdown in global demand and positive shocks due to lower prices for energy and other commodity imports. Current account deficits and thus gross external financing requirements are likely to come down. However, a substantial amount of external debt falls due in 2009. The financing of the current account deficits may prove less benign in 2009 than before, as FDI and other forms of foreign investment could dry up and the financial and non-financial private sectors may in particular encounter difficulties in servicing their external debts. Some countries may even have to use part of their official foreign exchange reserves in order to meet external financing requirements.

The financial sector, which initially remained relatively immune to the first-wave effects of the global financial crisis, cannot be insulated from the second-wave effects that are now becoming apparent. While the inter-bank lending market dried out worldwide, the rather high liquidity of local banks' balance sheets – to a large extent due to the unfavourable business environment that weighs on long-term lending - has to some degree shielded local banks in the Western Balkans from immediate liquidity tensions. EU-based parent banks even recently committed, in the case of Serbia, to maintain their financial exposure throughout 2009. However, there have been various degrees of deposit withdrawal in recent months in Bosnia and Herzegovina, Montenegro and Serbia. Measures taken by the authorities to reinforce guarantee deposit schemes somewhat contained these signs of mistrust. Because the banking sector is largely foreign owned, it has also benefited from state guarantees provided in the home countries of parent banks, which has had a clear stabilising effect on affiliated institutions in the countries of the region. But the liquidity crisis in the banking industry worldwide and the reduced profitability of a number of EU-based parent banks may weigh on the re-financing in 2009 of local Western Balkans subsidiaries that until 2008 relied heavily on their parent banks to finance their growth.

While the easing of inflationary pressures from import prices is a welcome development from the perspective of both financing needs and growth, it represents a formidable challenge for fiscal policy in the months ahead. Tax systems in the majority of candidate and potential candidate countries strongly depend on indirect taxation and customs where lower imports and domestic sales translate immediately into lower revenues. Revenue projections for 2009 may thus prove too optimistic, and the planned 2009 budgets may soon have to be adjusted. Refinancing budget deficits will become more challenging: in view of the expected dramatic increase in newly issued government securities in 2009 by the US and EU governments, investors' appetite for government bonds of a lesser standing may turn out to be very limited.

Fiscal policy thus is facing a challenge in the months ahead. An extraordinary negative shock to fiscal revenues after the deflation of bubbles in the commodities markets in 2007 and 2008 is putting additional downward pressure on the price level and most sources of public revenues. Tax revenue already started to drop abruptly in the first quarter 2009. The costs of financing government debt may rise substantially over the coming months, which would not only render the financing of any additional debt more expensive, but would also increase the cost of refinancing the existing stock of public debt, thus putting further pressure on public budgets. Unless courageous budget rebalancing exercises take place without delay budget deficits can therefore be expected to rise sharply.

2009 is therefore likely to see the reverse of what happened in 2008, when fiscal outcomes turned out more favourably in a number of cases (the former Yugoslav Republic of Macedonia, Kosovo, BiH, Albania). Governments currently expect fiscal swings (difference between expected budget outcome in 2008 and planned budget outcome in 2009) to be relatively moderate. But the mix of the liquidity crisis, the slowing of the real economy and deflating commodity bubbles sets the scene for fiscal sustainability problems, which will have to be addressed very soon. Policy reactions were still very defensive in the third quarter of 2008, but towards the end of the year and in early 2009 management of the spill-over effects of the international crisis moved to the top of the agenda of policy makers in candidate and potential candidate countries.

Overall, the current crisis is expected to have severe effects in the region as it challenges the recent growth model of Western Balkan economies, based on negative domestic savings and investment balances, cheap international capital, low investment in equipment and machinery, low exports, and in the poorest economies the expatriation of a sizeable part of the workforce. Financing domestic growth needs will become increasingly difficult. While FDI may resume once the international crisis is overcome, remittances flows may slow down and foreign capital is likely to remain less readily available, with higher risk premiums and rates. This will require an adjustment in external imbalances, supported by a more prudent policy mix. An acceleration of structural reforms on labour and product markets, and improving the quality of public spending would increase the capacity of the Western Balkan economies to compete with other emerging markets in attracting foreign investment in the recovery phase.

Part II

Investment matters: the role and patterns of investment in Southeast Europe

II. INVESTMENT MATTERS: THE ROLE AND PATTERNS OF INVESTMENT IN SOUTHEAST EUROPE

II.1. INTRODUCTION

The economies of Southeast Europe (SEE) have witnessed significant economic improvement since the conflict period of the 1990s. Growth was particularly strong in the past six years, however lower compared to other fast growing countries such as East Asia and the Baltics or some other New Member States. And while part of the difference with East Asia can be attributed to the faster population growth in the East Asia countries, population changes in SEE and in the New Member States have been similar.

Investment is a key driver of improved economic performance. The importance of investment for achieving sustainable economic growth has been empirically proven in fast-growing economies: investment contributes directly to total output, and also drives productivity improvements.

The purpose of this chapter is to provide policy insights to decision-makers, academics and researchers on the trends in investment in SEE. A comprehensive assessment of what determines investment is essential to identify, to the extent needed, policy actions that stimulate it. The chapter looks more in-depth into private investment trends in SEE, and explores some determinants of private investment, such as: the financing sources for investment, the contribution of FDI and the role of public investment. The selection has been made based on the relative importance and data availability for the SEE economies. Some key determinants of investment such as political stability and business environment have not been included because these are already well covered in the existing literature. Overall, this chapter aims to assess not only the quantity but also the quality of investment. It should be noted that while (investment in) human capital is equally, if not more, important for economic growth, its role and patterns in SEE are beyond the scope of the present analysis.

This chapter shows that investment rates in SEE are substantially lower than among the EU-8 and the fast growing East Asian economies, which could explain partly the slower economic growth in SEE. Investment levels have only started to increase in recent years in most SEE countries. Private investment, which usually drives productivity gains and should have a leading role, has been particularly low. Hence, achieving higher investment rates, and a better quality of investment, is an overarching objective and this poses an important challenge for policy makers in SEE.

Section II.2 describes the contribution of investment to growth; section II.3 provides stylized facts and analysis on private investment in the region; section II.4 provides insights on the financing of investment; section II.5 describes foreign investment trends in the region; section II.6 looks at public investment in SEE and its impact on private investment; and section II.7 summarizes the findings.

II.2. INVESTMENT, PRODUCTIVITY AND ECONOMIC GROWTH IN SEE

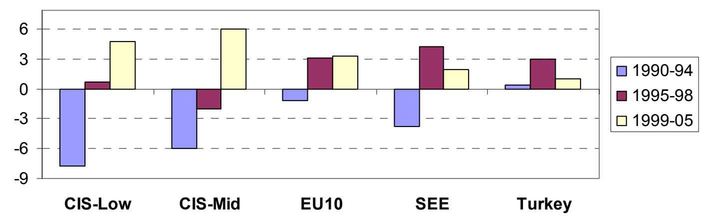
II.2.1. The contribution of investment and productivity improvements to output growth

The countries of Southeast Europe (SEE) have witnessed significant growth since the mid 1990s. Growth was particularly strong in the past six years, as the region recovered from conflicts and political turmoil, though lower compared to other fast growing countries such as East Asia and the Baltics or some other new Member States. The difference with East Asia can be partly attributed to the faster population growth in the East Asia countries, while population changes in SEE and in the New Member States have been similar. With the exception of the former Yugoslav Republic of Macedonia, all other SEE countries witnessed annual growth rates over the last decade in excess of 5 percent, and even the former Yugoslav of Macedonia has seen acceleration in its growth rates since 2003.

Output growth in SEE in the 1990s was mostly driven by a rise in TFP (World Bank 2008). TFP growth has followed a similar trend as in other transition countries during the first 15 years of transition. The first years of transition were accompanied by political and economic instability and uncertainty, and output fell in all transition economies. The fall in output was even larger in SEE, compared to Central Europe, partly because of the armed conflict in some parts of the region. All SEE countries had a negative TFP growth in the early 1990s, and since 1995 TFP growth in the region has been positive, though declining. Unlike in other transition countries, including the EU-10 countries, TFP growth in SEE declined from over 4 per cent in 1995-98, to some 2 per cent in the 1999-05 period.

These broad developments are to be attributed to the transition process. Most of the increases in TFP in SEE since the mid 1990s could be attributed to post-transition reallocation of resources (privatization of state property and re-starting of idle capacities), though structural reforms in this period also contributed to the productivity increase. Changes in factor utilization have also affected the movements in TFP. Capacity utilization fell in the early years of transition, which has been ascribed to the negative change of TFP. Later on this trend was reversed as plants and machinery were put back in use. Unfortunately, the impact of the changes in factor utilization on TFP growth cannot be precisely observed because of lack of data.

Graph II.II.1: **Total Factor Productivity Growth**



It seems that much of the easier part of transition-driven TFP growth has already been achieved in most of the SEE economies. The contribution of TFP declined from more than 4 percent during 1995-98 to about 2 percent during 1999-05. While SEE countries differ in their transition process, the slowdown in TFP growth could be explained by the leading contribution of simple reallocation of resources (through privatization) in the early years of the transition (see Kathuria, 2008). The transfer of public to private ownership is still ongoing in BiH and Serbia (share of private sector in GDP was just over 50% in 2006), and there is still room for further privatization-led TFP growth in these two economies, while in the other SEE economies the privatization process is fairly advanced. As this source of TFP growth will dry out over time, elevated and sustained TFP growth would need to come from further reallocation of resources and firm turnover, as well as from within-sector productivity improvements. The “Unleashing Prosperity” regional study confirms the dominant role of within-sector productivity growth in the EU-10 over 1999–2004.

Continued robust output rise would require new sources of TFP growth and increased contribution of capital and labour. Whereas in the long run sustainable growth is to be led by TFP, capital and labour could also be significant generators of growth. There is still strong potential for reallocation based (between-sector) TFP growth in SEE, but it varies among the economies and it might soon be exhausted in the more advanced ones. Hence, achieving robust and sustained growth would require a combination of increases in capital and labour as well as continuous improvement in TFP.

The hypothesis is that private investment needs to increase, especially if bearing in mind that productivity gains (TFP growth) often come from investment in new technologies (and human capital). Investment would also be needed to mobilize the abundant labour supply in most of the SEE economies. Labour participation is fairly low and unemployment rates in SEE are in double-digit figures in most of the economies. Notwithstanding the importance of other factors, such as the skills of the labour force and overall productivity, increased investment could contribute to employment creation, speed up growth and help resolve some of the social problems with which the region is confronted.

This section will only look at the role of physical capital formation as a contributor to output and stimulant to productivity increase is examined here, notwithstanding the fact that human capital formation is at least equally, if not more, important for the region .

II.2.2. Investment as driver of productivity

Investment underpins growth by bringing more inputs to the production process. But it is not just the value of additional inputs that matters for growth—it is the productivity gains that result from firms' investment in new technologies and more productive processes. As economies advance in the transition process, within-firm productivity growth becomes more important as a driver of productivity growth, while the "between" and "cross" sector reallocation of resources plays a lesser role (World Bank 2008). Investment can be a key driver of firm productivity growth in all sectors of the economy, especially as the sectoral specialisation of the SEE economies is still dominated by low value-added activities. Whereas countries like Czech Republic, Hungary, Poland and more recently Slovakia and Romania were able to attract investments in manufacturing activities such as car industry, information and communication technology (ICT) products or machines and equipment, the process has been lagging in the region.

Labour productivity in agriculture in the more efficient EU-8 countries was driven by capital deepening (and labour shedding). Large scale farms that have made substantial investments in fixed assets dominate the agriculture sector of the more productive countries, such as Hungary, Slovakia, Czech Republic, Estonia and Lithuania. On the other hand, the SEE countries are characterized by labour-dominant agriculture sectors, with small farms and little capital. Hence, the efficiency in the sector is far from desired levels compared to the more successful CEE countries.

Although there are many potential sources to improve TFP in manufacturing firms, experience in the transition countries has shown that productivity is often driven by efficiency gains in industries with higher capacity for innovation. In manufacturing, which accounts for the bulk of industrial output in SEE, a group of medium and high-technology industries achieved the highest average annual productivity growth rates. At the same time, these industries are among the biggest producers of ICT goods or use a relatively large amount of ICT capital. Hence, increased investments in ICT could promote faster growth in SEE, however, these economies need to be able to reap the benefits of ICT (e.g. to develop skilled labour force).

Services have a significant potential to drive growth in Europe and Central Asia (ECA), including in SEE countries, and TFP growth in services is closely linked to capital deepening in this sector. Service productivity growth in transition economies has been driven by strong performance in 'backbone' industries: transport, telecommunications and financial intermediation services. Productivity growth in these sectors in ECA over 1997-2004 outperformed average productivity growth in EU-15 countries. All three sectors are capital intensive, and sustaining the growth momentum will require further investment. The investment would need to come from both the public and the private sector: whereas transport infrastructure is most often provided by the public sector, financial services and telecommunications are almost fully in private ownership in SEE.

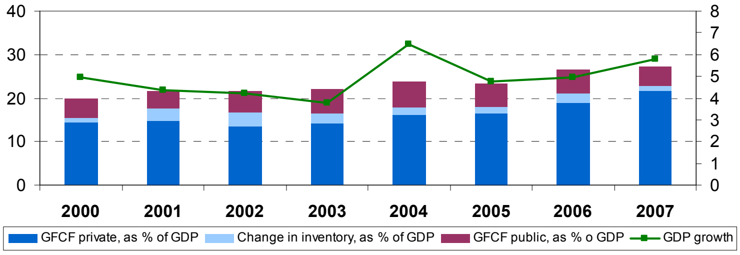
II.3. PRIVATE INVESTMENT IS CRITICAL FOR SUSTAINED RAPID GROWTH

II.3.1. Private capital formation in SEE

The section below analyzes some of the key determinants of private investment in SEE as well as the relationship between private investment and growth using sectorial data for these economies. It aims to focus on the links between investment, productivity and growth in SEE, deliberately leaving aside some of the biggest factors for investment such as political stability and business environment, that are sine qua non conditions for a more spectacular increase in (domestic and foreign) investment in all SEE economies.

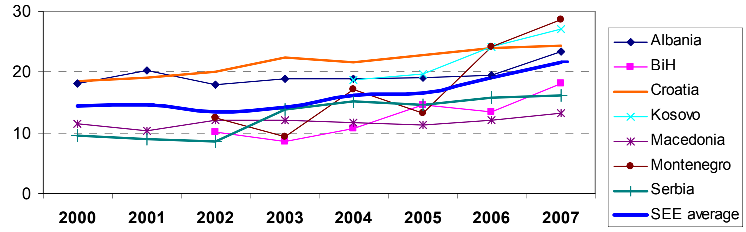
Capital accumulation in SEE is low compared to world averages, which partly explains the gap in growth rates compared to other (fast-growing) regions in the world. Indeed, numerous empirical studies have found investment to be a lead determinant of economic growth: Bosworth and Collins (2003) and Levine and Renelt (1992) have found that of the determinants of growth, investment to GDP has the largest explanatory power. This finding was also confirmed in the report of the Growth Commission (2008), which concludes that countries with high and sustainable growth invest a significant share of income (total domestic and foreign investment often exceeds 25 percent of GDP). What is more worrisome for the region is that private investment is also quite low. Private investment's share to GDP, including change in inventory, hovered at around 17 percent of GDP until 2003, and started to pick up only in 2006.

Graph II.II.2: **Gross capital formation7 (investment), as percent of GDP and GDP growth in SEE8**



The improved performance in 2004-07 varied among the SEE economies. As can be seen from the figure below, the increase in the share of private gross fixed capital formation to GDP ratio was strongest in the two smallest economies, Montenegro and Kosovo, and Bosnia and Herzegovina, whereas improvements in the rest of the region were moderate. In terms of level, investment exceeded 25% of GDP only in Montenegro, Kosovo and Croatia in 2007.

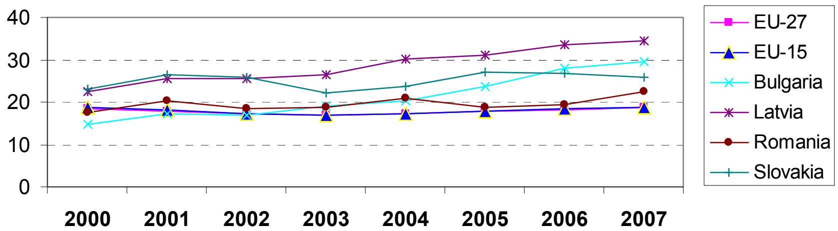
Graph II.II.3: **GFCF private as percent of GDP in SEE**



Source: World Bank databases

Even though the private investment to GDP ratio in SEE is above the EU average, it is significantly below the levels achieved by the EU-10. The gap for SEE is negative even when comparing with investment levels in the EU-10 countries in earlier years of transition (since the EU-10 are more advanced in the transition process). For example, Slovakia's and Latvia's private investment share in GDP was around 25 per cent in the 2000-03 period, one fifth higher than the ratio for the SEE countries in 2007. Furthermore, most of the fastest growing EU-10 countries, in particular Bulgaria and Latvia, but also Estonia, accomplished a notable increase in capital outlays between 2000 and 2007.

Graph II.II.4: **GFCF private, including change in inventory, as percent of GDP**



Source: Eurostat

Gross fixed capital formation comes in two forms: construction or machinery and equipment (and other). Research by J. Bradford DeLong and Lawrence Summers confirmed the robust positive relationship between investment in machinery and equipment (M&E) and productivity. In all SEE countries except for Serbia, construction accounts for more than half of GFCF (see table below). Construction is an essential form of almost any investment activity, yet, acquiring M&E, in particular more sophisticated technologies, would signal a move towards higher productivity sectors. Between 2004 and 2005, the share of construction increased in Croatia and Serbia and remained unchanged in the former Yugoslav Republic of Macedonia. Montenegro, on the other hand, achieved a sizable move from construction to M&E: the share of M&E rose from 33.6 to 40 percent of GFCF.

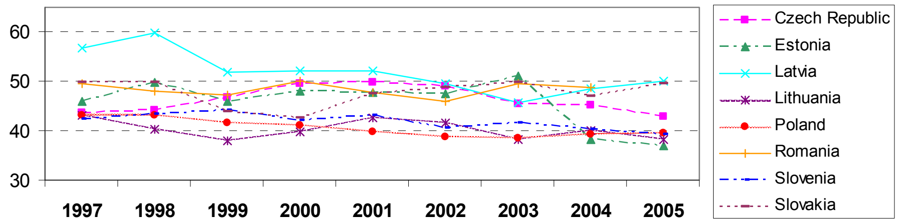
Table II.II.1:
GFCF by technical structure, (2004-5 average)

	BiH	Croatia	FYR Macedonia	Montenegro	Serbia
Construction	53.9	56.1	59.1	55.4	44.5
Equipment	42.8	36.2	37.4	37.0	48.1
Other	3.4	7.8	3.5	7.6	7.4

Source: National statistical offices

In contrast, firms in most EU-10 countries spend more on M&E than on construction. As the figure below points out, M&E in the fast growing EU-10 economies accounted for between 45 and 50 percent of GFCF prior to joining the EU; in Latvia, the share was above 50 percent until 2002. Moreover, the EU-10 economies invested even more in M&E in the earlier years of transition, and the shift towards higher spending on construction could partly be explained by the inflow of EU pre-accession funds for (transport) infrastructure and the booming residential sectors. The gap in the GFCF structure between SEE and the EU-10 is even greater if measured in real terms. Whereas prices of investment goods are more or less homogenous in the EU-10 and the SEE countries, prices of construction goods are considerably lower in SEE (apart from Croatia).

Graph II.II.5: **GFCF in machinery and equipment in some of the EU-10**



Source: Eurostat

II.3.2. Sectorial investment patterns

The sectorial distribution of investment, to begin with, depends on the structure of the economy. Within the SEE region, the former Yugoslav republics have a more or less similar structure: agriculture accounts for some 10 percent of value added, the industry's share is about one quarter, and services account for close to two thirds of value added. Albania differs in the size of its agriculture sector, which accounts for over 20 percent of value added, while industry and services account for about one fifth and over half of valued added, respectively.

A more detailed look at the sectorial structure (NACE level) of the SEE economies reveals some heterogeneity among the economies. In manufacturing, financial services and real estate, discrepancies exist among groups of countries. For example, the share of manufacturing is much greater in Croatia and the former Yugoslav Republic of Macedonia compared to the rest of the region. In other sectors, such as construction, hotels and restaurants and transport and communications, the economy structure is similar, with one or two outliers in each sector.

Table II.II.2:

GDP structure (NACE) of the SEE economies* (in percent)

	Albania	BiH	Croatia	Kosovo	Macedonia	Montenegro	Serbia	SEE average
Agriculture	16.2	10.1	7.3	8.6	13.3	10.4	13.5	***11.3***
Fishing		0.0	0.2	0.0	0.0	0.0	0.0	***0.1***
Mining and quarrying	0.8	2.3	0.8	0.0	0.6	1.7	1.6	***1.1***
Manufacturing	13.1	11.7	19.4	15.1	19.6	9.8	16.3	***15.0***
Electricity, gas and water supply		5.3	3.2	0.0	4.0	5.6	3.3	***3.6***
Construction	22.4	4.8	6.6	12.0	6.8	3.6	3.4	***8.5***
Wholesale and retail trade, etc.		15.7	12.5	10.2	15.9	12.5	11.1	***13.0***
Hotels and restaurants		3.7	3.6	3.3	1.7	3.5	0.9	***2.8***
Transport and communication	9.6	8.8	10.1	4.8	10.4	11.3	10.8	***9.4***
Financial intermediation		4.1	5.9	4.9	4.3	2.9	6.8	***4.8***
Real estate, business activities etc.		10.8	11.2	18.8	3.6	13.9	14.6	***12.2***
Public administration and defense		10.1	6.7	20.3	8.3	10.9	7.3	***10.6***
Education		5.2	4.5	0.5	4.2	5.1	3.2	***3.8***
Health and social work		4.6	4.9	1.0	4.5	5.4	4.9	***4.2***
Other community activities		2.9	3.0	0.7	2.8	3.5	2.1	***2.5***

** Albania, Bosnia and Herzegovina, and the former Yugoslav Republic of Macedonia data for 2006; Serbia, and Montenegro for 2005; Croatia, and Kosovo for 2004. For Kosovo, manufacturing figure includes mining and electricity, gas and water sectors.*

Source: National statistical offices

The distribution of investment by sector, relative to the sector's share in value added, varies considerably across the region. All countries have more or less similar share of investment in agriculture, fisheries and mining sectors relative to those sectors' share in value added. Investment shares diverge substantially in manufacturing, construction and hotels. According to the table below, manufacturing firms in BiH and Serbia invest much more compared to firms in Croatia, the former Yugoslav Republic of Macedonia and Montenegro. It seems that the electricity, gas and water supply sectors in Montenegro have invested less compared to the rest of the region. On the other hand, investment in hotels and restaurants has been very high in Montenegro as a result of the booming tourism industry. Investment in construction in the former Yugoslav Republic of Macedonia is disproportionately high, which might be partly due to data comparability issues.

Table II.II.3:

Difference between the share of investment and share of value-added for NACE sectors, in percentage points

	BiH	Croatia	Macedonia	Montenegro	Serbia
Agriculture	-8.2	-4.8	-9.7	-8.8	-10.0
Fishing	0.0	-0.2	0.0	0.0	0.0
Mining and quarrying	-0.1	0.6	0.0	0.1	-0.6
Manufacturing	8.1	-5.7	-7.0	-3.6	5.0
Electricity, gas and water supply	2.1	4.3	5.6	-0.6	3.6
Construction	-0.5	5.7	28.6	-1.9	0.7
Wholesale and retail trade, etc.	5.3	1.5	-6.1	-4.5	4.9
Hotels and restaurants	-2.6	0.4	1.1	25.1	0.2
Transport and communication	3.1	0.4	3.1	9.3	2.4
Financial intermediation	1.2	1.2	-1.7	1.5	-3.1
Real estate, business activities etc.	-6.0	0.1	-2.6	-9.5	0.6
Public administration and defense	4.8	4.3	-3.3	2.0	1.6
Education	-4.0	-3.7	-3.4	-2.3	-2.0
Health and social work	-2.4	-3.3	-3.1	-4.4	-3.2
Other community activities	-0.9	-0.6	-1.6	-2.4	-0.1

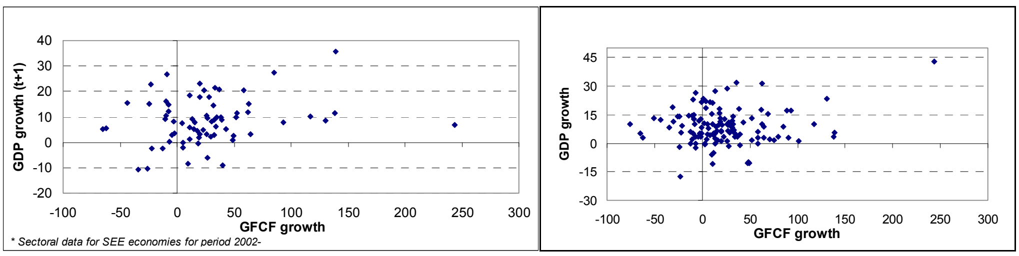
Source: national statistical offices

II.3.3. Sectorial investment, output and labour productivity

This sub-section compares sectorial investment and output through several indicators for which data is available. While more sophisticated econometric analysis would be needed to assess more accurately the links between the variables, the correlations and simple regressions bring out some interesting insights.

A simple comparison between sectorial investment and output shows that more investment in a sector has not necessarily led to higher output growth. The two figures below compare the impact of changes in GFCF on changes in value added (on NACE sector level). The figure on the left looks at changes in value added in the subsequent period (t+1) and the right figure shows changes in the same period: neither shows a strong relationship between the two (the correlation between the two indicators is extremely low (0.14)). This is to some extent expected since other factors, apart from the quantity of investment, play an important role, such as the quality of investment, technological progress and the structural differences between public services and sectors dominated by private firms.

Graph I.2.6: **Investment and output growth in SEE by sector**
(with and without time lag), in percent



There is mixed evidence to whether labour productivity has increased faster in sectors that have received a high share of investment. Investment in transport and communications has been significant in all (four) countries for which data was available, and the productivity increase in this sector has been greater than the average. In manufacturing the results are mixed: Croatia and the former Yugoslav Republic of Macedonia had a larger than average productivity growth, while Montenegro and Serbia had positive but lower than average increases in productivity. On the other hand, productivity increases in the financial sector were high in all countries, while investment in this sector has been relatively low. The sectorial differences in investment and labour productivity are partly explained by the variations in capital (and labour) to output ratios.

The link between investment and productivity seems to be strong when comparing investment per employee and labour productivity. First, the correlation between sector labour productivity and GFCF per employee is 0.5. Investment per employee is the highest in the electricity, gas and water supply, transport and communication and financial sectors; and at the same time, these are the most productive sectors in terms of output per employee. Secondly, sectors that have invested more than average per employee have achieved a faster improvement in labour productivity.

Table II.II.4:

Increase in sector labour productivity compared to the average, and sector investment per employee compared to the average

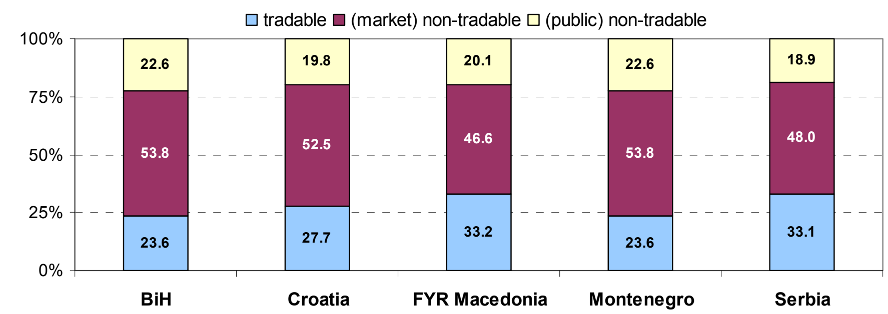
	Croatia		FYR Macedonia		Montenegro		Serbia	
	labor productivity	GFCF	labor productivity	GFCF	labor productivity	GFCF	labor productivity	GFCF
Agriculture	72	84	198	17	127	134	39	15
Fisheries	…	…	…	…	…	…	…	…
Mining and quarrying	116	159	638	92	209	42	135	84
Manufacturing	132	64	135	69	62	39	85	116
Electricity, gas and water supply	179	269	15	306	-168	129	-99	378
Construction	196	208	38	447	0	317	-54	73
Trade	22	93	98	66	201	61	255	115
Hotels and Restraurants	107	114	-116	115	-125	144	7	33
Transport and Communications	150	130	128	284	127	164	253	253
Financial intermediation	151	256	242	241	419	149	168	198
Real estate, etc.	58	154	-43	52	-89	621	175	484
Public administration and Defense	90	113	31	66	379	29	57	161
Education	92	10	83	15	158	15	18	21
Health and Social Works	68	17	-3	45	308	13	40	32
Other Public Services	7	68	70	36	42	104	32	42
Average	*100*	*100*	*100*	*100*	*100*	*100*	*100*	*100*

Source: national statistical offices

Beyond the data imperfection one would have to consider that the link between sectorial investment, output and labour productivity is not as straightforward. Many factors other than capital formation influence output and productivity, with human capital and endogenous technological progress being the most important ones. For example, the financial sector has attracted foreign investment, which in turn has brought positive spill-overs (better organizational and managerial skills), so the increase in output and labour productivity comes from this factor. Nonetheless, investment plays an important role as it not only brings new inputs but is the key driver of technological progress.

Another way of measuring investment efficiency is by looking at the allocation in tradable vs. non-tradable sectors. According to an IMF study on vulnerabilities in SEE, non-tradable sectors tend to have lower productivity. In the region, investment in non-tradable sectors accounts for between 66 and 76 percent of total investment, of which about a third is in public services. The countries that invest the most in the tradable sector are the former Yugoslav Republic of Macedonia and Serbia.

Graph II.II.7: **Gross fixed capital formation by sector13 (period average*)**



** BiH (2003-06), Croatia (2002-04), FYR Macedonia (2002-06), Montenegro (2002-05), Serbia (2002-05)*
Source: national statistical offices

II.4. FINANCING INVESTMENT

II.4.1. The link between savings and investment

The level of investment in any economy depends to a large extent on the availability of domestic savings. High-growth economies typically set aside a formidable share of their income: a national saving rate of 20–25 percent or higher, is not unusual (Growth Commission, 2008). Some countries rely more on attracting foreign savings, however, domestic savings remains the most important factor. Savings rates in SEE have been extremely low. Moreover, national savings rates fell in each of the SEE countries except for Croatia between 2000 and 2005 (Kathuria, 2008). At the same time, public savings rose during 2000–05 (except for the former Yugoslav Republic of Macedonia), which means the fall in private savings was even greater and driven by robust advances in domestic consumption..

The Western Balkans Integration study of the World Bank finds a strong and positive correlation (of 0.8) between national savings and investment rates in SEE (Kathuria, 2008). The report also finds that in the wider SEE region (including Bulgaria and Romania), Bulgaria and Croatia achieved the largest increases in savings and investment during 2000–05. Given the above link, domestic savings become extremely important. It suggests that governments should encourage the accumulation of domestic savings to help finance domestic investment and try to limit potential vulnerabilities related to tapping foreign savings (foreign loans).

II.4.2. The role of the financial sector

Financial services are an important determinant for investment in any economy, big or small, developed or developing. Lack of access to external finance can discourage new entrepreneurs and incumbent firms from investing in new ideas which ultimately retards economic growth (Access Finance 2007). Erden (2005) and Ramirez (2006) also point out to the importance of credit for achieving higher investment rates. In countries with underdeveloped financial sector, firms are left with their own resources to realize their growth potential, but that is rarely enough. In addition, Mileva (2008) finds that transition economies with better-developed financial markets attract more foreign loans (which are mostly from parent banks to local subsidiaries) and around 50 percent of foreign loans are then used for financing domestic investment.

In SEE, the largest source of funding for investment remains firms' own resources. Overall, in those countries for which data is available, between 54 and 71 percent of investment is financed from own resources. Only in Montenegro more investment was financed from credit (48 percent). The dependence on own funds vs. credit varies sector by sector. For example, in agriculture, manufacturing and trade, most investment comes from own funds. Then, as expected, only a small part of investment in public services is financed by loans. In contrast, firms in real estate and hotels business more often use loans to finance investment in Croatia and Montenegro (the two countries with developed tourism sector). Other sectors, such as mining and fishing, show mixed results.

Table II.II.5:

Sources of financing of investment

	BiH Federation		Croatia		FYR Macedonia		Montenegro	
	own sources	credit	own sources	credit	own sources	credit	own sources	credit
Agriculture, hunting and forestry	68.2	9.3	80.6	17.0	58.2	41.3	100.0	0.0
Fishing	0.0	83.3	58.3	47.2	0.0	0.0	100.0	0.0
Mining and quarrying	46.2	26.8	18.5	78.1	91.3	8.5	50.3	49.7
Manufacturing	51.4	34.0	81.3	18.2	86.8	11.3	71.7	19.9
Electricity, gas and water supply	56.7	20.9	62.7	14.6	74.5	25.5	60.7	36.3
Construction	60.6	23.2	39.6	47.5	76.4	11.8	74.1	24.6
Wholesale and retail trade	52.4	32.9	67.0	30.8	75.7	22.2	66.8	32.5
Hotels and restaurants	53.1	21.9	44.3	55.7	75.3	24.7	4.2	95.8
Transport and communication	66.2	17.2	61.0	29.7	78.2	21.2	43.0	56.9
Financial intermediation	73.8	1.6	59.2	42.5	65.4	34.6	98.5	0.2
Real estate and business activities	53.8	30.3	38.8	41.5	67.3	21.4	23.0	26.6
Public administration and defence	82.6	1.4	27.7	9.0	43.7	2.8	20.8	1.4
Education	35.0	2.5	46.1	8.1	56.0	0.3	85.6	0.6
Health and social work	40.8	6.1	30.9	41.5	90.9	0.0	77.3	0.3
Other social services	36.0	18.0	59.5	20.5	82.3	10.2	56.3	6.6
Total	**58**	**23**	**54**	**30**	**71**	**17**	**38**	**48**

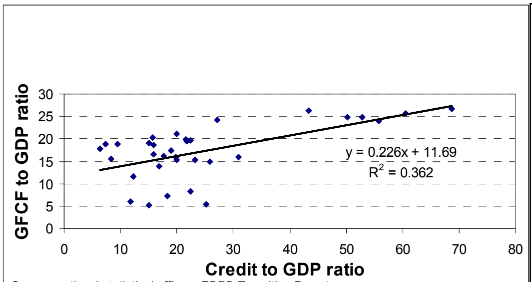
Source: national statistical offices

The structure of source of financing confirms the importance of the financial (banking) sector for investment. Financing investment by credit is more common in Croatia and Montenegro, which have the most developed banking sector (as measured by the share of private sector credit to GDP). On the other hand, firms in BiH (Federation only) and the former Yugoslav Republic of Macedonia, which have a less developed banking sector, rely more on own resources.

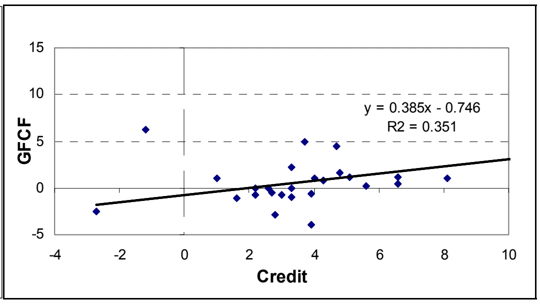
Firms in industries that depend highly on external finance tend to enjoy higher productivity growth, which makes the role of external finance even greater (World Bank, 2008). The productivity growth is even higher in countries with a more developed financial sector. This finding of the ECA-wide study is confirmed in the case of Croatia, which has achieved the highest financial development. All the sectors that depend highly on external finance have pulled off a higher growth in productivity.

The dynamic financial sector played an important role in the enlargement of the capital base in the region, which points to a conclusion that access to finance had previously constrained firm expansion. The correlation between the credit to private sector to GDP ratio and private investment's share in GDP is relatively high (0.6). Montenegro is the best example to illustrate the link between credit and investment; in 2002-06 it achieved the highest investment growth in the region (11 percentage points of GDP) and the strongest credit growth (rising from 8 percent to 43 percent of GDP).

Graph I.2.8: **Private investment and credit as percent of GDP (lhs), annual changes in investment and credit to GDP in percentage points (rhs) in SEE (2002-06)**



Source: national statistical offices, EBRD Transition Report



While the link between credit growth and investment is strong, there seems to be little correlation between capital market developments and private investment in SEE. Despite the substantial deepening of the stock markets in the region in the past 4-5 years, GFCF growth has not necessarily responded to the capital market boom. In other words, countries which had large increases of stock market capitalization did not necessarily have a higher increase in private investment. For example, BiH's private GFCF share in GDP rose by only 2.6 percentage points between 2003 and 2006, while the stock market capitalization went from 10 percent to over 100 percent of GDP in the same period. At the same time, Montenegro's private GFCF to GDP ratio increased by 15 percentage points, while stock market capitalization rose by merely 8 percentage points of GDP. Mileva (2008) also finds that portfolio flows in transition economies had no effect on capital formation.

The limited impact of the stock market boom on investment can be partly explained by the still low level of market deepening. The remarkable increase of stock market capitalization in SEE has been driven almost entirely by the increase of the value of shares of listed companies. Prices soared as foreign (portfolio) investors began to show interest in the (undervalued) listed firms. This initial increase in demand fuelled domestic speculation which drove prices even further up. However, none of the SEE stock exchanges, except for Zagreb, has had an initial public offering. At the same time, again except for Croatia, there have not been any corporate bond issues in the region. Finally, venture capital is practically non-existent in the region, which is not unexpected. The ratio of venture capital to GDP is also very low in the more advanced European economies. To illustrate, in Poland and the Czech Republic it is about 0.1 percent of GDP. In addition, most of this venture capital goes to mature companies (Ben-Ari and Vonortas, 2005).

The recent turmoil in global financial and capital markets could have negative spill-over effects on the banking sector in SEE and in turn become a constraint on private investment. According to Raiffeissen Bank's CEE Banking report 2008, credit growth in SEE remained robust in 2007 and, to a lesser extent, in the first half of 2008, despite the global credit crunch. At the same time, investment growth was also strong in 2006 and 2007 in most SEE economies. However, few European banks have a sizeable share of the banking sector in SEE, and risks remain that if some of these banks are more severely affected by the liquidity crisis, the credit supply to local banks in SEE is reduced. In such case, investment growth is likely to decline in many SEE economies.

II.4.3. Remittances as a source of investment

The large remittance flows to the region may have led to increased investment. The Migration and Remittances report of the World Bank (World Bank, 2006) finds significant empirical evidence that remittances have enabled (directly or indirectly through savings) higher investment rates. These findings apply for both European countries and for other regions of the world. According to the IMF (2003), remittances are not primarily meant to serve as capital for economic development, but as compensation for poor economic performance. Nonetheless some part of remittances is used for investment; it is noted in IMF (2007) that a quarter of remittance flows in the former Yugoslav Republic of Macedonia have been used for investment.

The SEE economies are large recipients of remittances even in global terms, in particular Albania, BiH, the former Yugoslav Republic of Macedonia and Kosovo. While detailed and reliable data on remittance flows and their use is lacking in SEE, the importance of these flows for capital formation should not be neglected. More detailed research is needed to analyze the exact impact of remittances on capital formation in order to determine how government policies could channel a larger part of these funds towards investment.

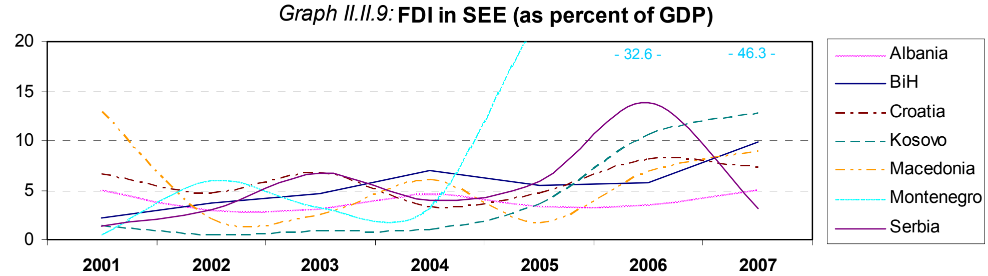
II.5. THE ROLE OF FOREIGN INVESTMENT FOR DOMESTIC CAPITAL FORMATION

Foreign direct investment is positively related to domestic private investment; it is important for capital formation, both in terms of green-field investment and acquisition, because it not only increases the capital stock, but also leads to technological spill-overs. A summary of recent literature on the relation between FDI and economic growth by Lim (2001) finds there is good evidence that FDI efficiency spill-overs exist and that FDI is positively correlated with growth. Spill-overs come through the introduction of new technologies which means that FDI stimulates private investment in new technologies. The new technologies, together with the new organizational skills, overseas markets and supply chains, may actually be worth more than the initial capital itself.

When it comes to assessing domestic capital formation in an economy, the term "foreign direct investment" is a misleading concept. FDI includes not only physical investment of foreign-owned companies in host economies (such as green-field investment), but also the transfer of existing assets from domestic to foreign ownership (acquisition of domestic by foreign firms). Whereas the former directly contributes to the increase of capital stock, the latter has no direct and immediate effect on capital formation. Nonetheless, privatization and acquisition of domestic enterprises by foreign firms leads to further investment flows (capital formation) and raises firm productivity. Most FDI inflows in SEE, and throughout the world, go in the second category: purchase of existing capacities (firms) by foreign firms. In SEE this is even more so, as FDI has been mostly related to the privatization process where state-owned firms were sold to foreign companies.

Foreign investment has stimulated investment across the SEE region. Private capital formation rose faster in those economies that managed to attract more FDI. In 2001-07, Montenegro recorded the highest level of foreign investment (relative to GDP); consequently, its ratio of private investment to GDP rose by some 13 percent (highest in the region). The case of Albania confirms this finding from the other side of the spectrum; Albania was the least successful country in attracting FDI, and its private investment to GDP ratio actually slightly declined in this period. However, not all countries fit in the picture. Bosnia and Herzegovina and the former Yugoslav Republic of Macedonia were moderately successful in getting foreign investment, but significant increases in capital formation have not materialized.

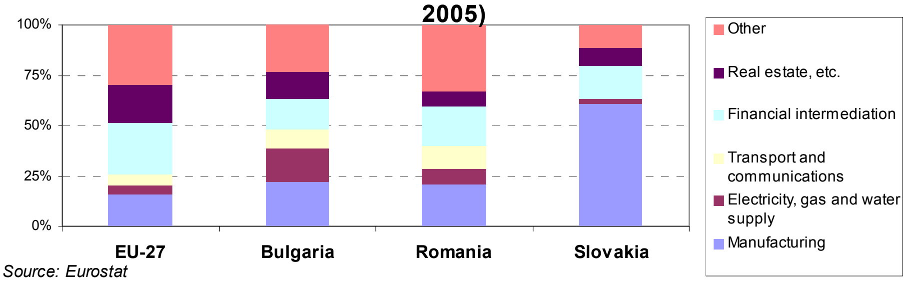
Graph II.II.9: **FDI in SEE (as percent of GDP)**



Source: IMF, national central banks, World Bank regional tables

Foreign investment in recent years has been concentrated in only a few sectors: manufacturing and financial sector received highest interest of investors. SEE's banking sector has attracted substantial foreign investment; in most economies foreign-ownership in the sector is above 80 percent. The former Yugoslav Republic of Macedonia is a slight outlier in this regard, because: (1) it still has a relatively low share of foreign presence in the banking sector, and (2) foreign banks that are present on the market, entered earlier in the transition process. Similar trends of bank consolidation are observed both in the EU-15 and in the EU-10. A considerable share of foreign investment in SEE has gone into manufacturing, though much less than in, for example, Slovakia. In 2000, the share of projects in manufacturing peaked to 74 percent. As a matter of fact, SEE firms, unlike Slovak firms, have not managed to seize the opportunities presented by the trends of off-shoring in developed economies. This partly explains the high share of foreign investment in (non-tradable) services. On the other hand, some of the most emerging sectors for FDI in SEE in recent years have been business services, automotive components and software.

Graph II.II.10: **FDI by sector in the EU (average for 2004 and 2005)**



Source: Eurostat

II.5.1. FDI is associated with higher quality of investment

Empirical evidence shows that foreign-owned firms tend to have higher productivity growth than domestic private or state firms. Notwithstanding the fact that the productivity difference may be partly explained by the initial difference at entry ('cherry-picking' approach of foreign firms); in number of cases foreign-owned firms have shown higher 'within' productivity growth. In addition, new technologies from foreign firms can have positive spill-over effects on domestic firms. The literature distinguishes between horizontal spill-over effects (within an industry) and vertical spill-over effects (generated by linkages in the production or value chain).

In most cases, foreign entry led to improved productivity in those sectors. The link between FDI and TFP is well documented. Djankov and Hoekman (2000) analyze firm-level data for the Czech Republic during 1992-96 and find that foreign investment has the predicted positive impact on the TFP growth. In SEE, the link between FDI and productivity is well confirmed in the financial sector: productivity increases were higher than average in all countries for which data is available. From a country perspective, 3 out of the 4 sectors with substantial FDI in the case of Croatia, the former Yugoslav Republic of Macedonia and Serbia had higher than average productivity increase (data not available for the other countries).

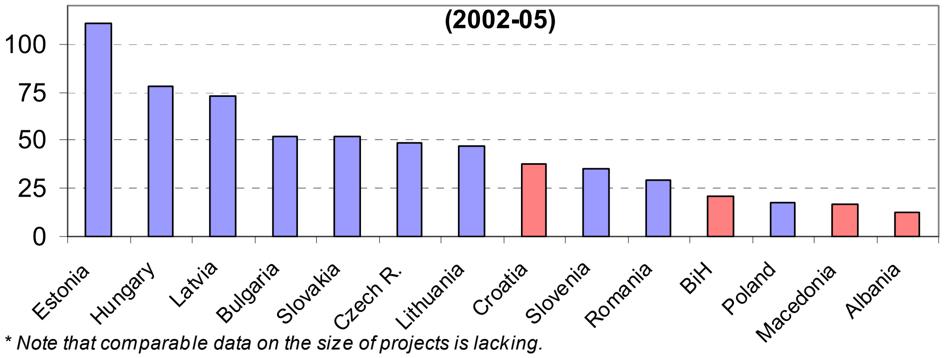
Table II.II.6:
FDI in key sectors and change in labour productivity in those sectors, in percent

	FDI by sector (period average)				Labor productivity (change in period)			
	BiH	Croatia	Macedonia	Serbia	BiH	Croatia	Macedonia	Serbia
	2004-6	*2000-04*	*2003-6*	*2004-5*	*2006**	*2004-2*	*2006-2*	*2005-2*
Manufacturing	17.7	28.3	20.9	23.3	-44.4	22.0	42.1	10.7
Electricity, gas and water	0	3.1	35.2	0	41.6	29.9	4.5	-12.5
Transport and communication	4.9	10.4	6.5	27.4	-1.9	3.7	30.3	32.2
Trade	25.5	13.0	11.3	1.0	31.5	25.0	39.7	32.0
Financial intermediation	40.7	29.2	7.4	27.8	133.2	25.1	75.2	21.3
Average productivity					*0.0*	*16.7*	*31.1*	*12.6*

** Difference (in percent) compared to average productivity (data available only for 2006).*
Source: national statistical offices

The SEE region has so far lagged in attracting greenfield foreign investment. Apart from being concentrated in only a few sectors, FDI has been mostly related to privatization and the sale of assets. Greenfield investment has been marginal, which means only a fraction of the FDI contributed directly to gross fixed capital formation. Croatia has been the best performer in terms of attracting foreign investment, but even there, the number of greenfield FDI projects has been lower than in the Baltics or some of the other more successful EU-10 countries.

Graph II.11: **Greenfield FDI in selected transition economies***
Number of greenfield FDI projects divided by population
(2002-05)



** Note that comparable data on the size of projects is lacking.*
Source: IMF staff estimated based on World Investment Report 2006

Nonetheless, the increasing flow of foreign investment will stimulate fixed capital formation in the future. According to FIAS (2006), almost half of foreign businesses established in the SEE reported plans to further expand their operations, and this would be through an expansion of existing facilities. And only 12 percent of established foreign businesses indicated that they were considering scaling down their operations and/or relocating to other countries.

Last but not least, geography seems to matter for foreign investors. Foreign investment in SEE has followed two patterns in terms of where investors are coming from. The bulk of foreign investment has come either from neighbouring countries or from European companies that have taken a regional approach in entering the SEE market. Indeed, in fact all countries, except Montenegro which is surrounded by other SEE countries, immediate neighbours were the largest or among the top five investors. At the same time, large European companies have targeted the entire region as one market. For example, Austrian banks have acquired local banks in all countries, except for the former Yugoslav Republic of Macedonia. Deutsche Telecom (or its subsidiary Magyar Telecom) owns the incumbents in Croatia, the former Yugoslav Republic of Macedonia and Montenegro.

Table II.II.7:
FDI stock in SEE by country as percent of total stock

	BiH	Croatia	YR Macedoni	Montenegro	Serbia
Austria	39.5	27.6	10.5	7.6	12.5
Netherlands	3.2	16.7	10.1	1.0	7.3
Hungary	…	6.0	16.7	13.4	3.6
Germany	8.5	13.8	3.0	4.8	16.6
Switzerland	6.7	0.9	7.2	8.7	1.1
Greece	…	0.0	15.3	1.4	16.3

** Croatia - stock from 1993 till Q3 of 2007, BiH - stock until 2006, Macedonia - stock until 2006, Serbia - between 2000 and 2006*
Source: national central banks

II.6. PUBLIC INVESTMENT CAN FUEL PRIVATE INVESTMENT

The literature on the nexus of public and private investment in developing economies is mixed. A recent survey of studies on the impact of infrastructure on growth found a positive and significant link in 63 percent from a total of 140 specifications in 64 papers. The explanation for the different views, on whether public investment crowds-in private investment, may be that other factors influence this link.

The Growth Commission (2008) reaffirms that it is difficult to sustain rapid growth without high rates of public investment. Investment in infrastructure, but also in education and health, crowds in private investment by increasing the efficiency of private capital. Several studies have concluded that East Asia's much higher investment in infrastructure explains a large part of its faster growth than Latin America (Economist 2008). Erenburg (1994) provides evidence that public investment in infrastructure stimulates capital formation.

II.6.1. Public infrastructure in SEE

Investing in infrastructure is vital for promoting investment and stimulating economic growth. In situations where the public sector can carry out more efficiently such infrastructure projects, it positively affects returns on private investment; hence, it increases the incentive and opportunities for private investment. Firms in countries with access to modern telecommunications services, reliable electricity supply, and efficient transport links, are more productive that those operating in countries without them. Hence, infrastructure deficiencies which are existing in SEE countries, negatively affect private investment and growth. The SEE economies are relatively poor, so it is not surprising that infrastructure is in a worse shape than in the more advanced European economies. For instance, the quality of public infrastructure in the SEE economies, especially of transport and telecommunications, is significantly lower than in EU-10 or faster growing economies and impacts negatively economic activity. The endowment with infrastructure is however very uneven within the region: Albania and Kosovo started the transition with some of the poorest existing infrastructure in Europe, compared to a rather favourable situation is Croatia or Serbia. Regional disparities are also considerable as regards infrastructure. Other factors such as the level of competition, regulatory frameworks and efficiency of operations and maintenance also are important determinants of the stock and quality of infrastructure.

Service costs are important for all firms, and to some extent they depend on public investments. High-quality market services such as transport or telecommunications affect production costs and consequently the competitiveness of firms in all sectors. Furthermore, the quality of public services can also influence the attractiveness to foreign investment. According to the World Bank (2008), services contribute on average around 10–20 percent to the production cost of a product and account for all trading costs (transport, trade finance, insurance, communications, and distribution services).

Public investment in SEE as a share of GDP is substantial, because of the large infrastructure needs and poor quality of infrastructure. Public investment has a significant share in gross fixed capital formation in several SEE countries. While overall public investment is relatively high, it remains unclear to which extend it has been conducive to private investment. Moreover, government capital outlays have increased in most countries in recent years, despite the substantial downward adjustment of overall government expenditure. Within the region, Albania, BiH and Kosovo dedicated larger shares of spending to capital projects, thanks to the large funds coming from the donor community. At the same time, these three economies had a poorer endowment with public infrastructure at the beginning of the transition (and after the conflict in the case of BiH and Kosovo). Of the other countries, Croatia and Montenegro spend more on capital investment; in Croatia, most of these expenditures went to upgrading the road network.

Table II.II.8:

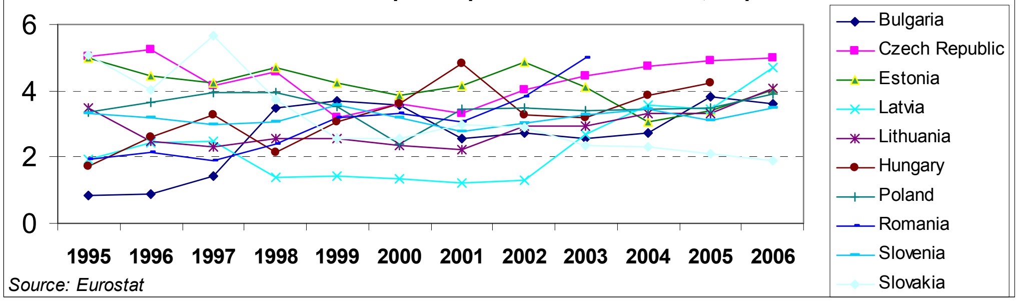
Public investment, as percent of GDP

	2003	2004	2005	2006	2007	average
Albania	4.6	5.0	4.6	5.6	5.9	5.1
BiH		7.0	6.8	6.3	7.2	6.8
Croatia	5.7	5.0	4.4	4.0	4.0	4.6
Kosovo		10.6	8.1	6.2	4.9	7.5
Macedonia, FYR		3.2	3.8	3.0	3.7	3.4
Montenegro		3.0	4.1	5.5	6.2	4.7
Serbia	2.4	2.5	2.6	3.8	4.2	3.1
of which foreign financed:						
Albania	1.9	1.4	1.7	1.4	1.5	1.6
BiH		4.7	4.1	3.2	3.2	3.8
Kosovo		3.4	1.4	1.8	1.3	2.0

Source: IMF staff reports

Capital investment in SEE as a share of GDP is higher than in the more advanced European economies. Most economies in the region have higher capital expenditures than the EU-10 countries with largest capital spending. The difference is even greater when comparing with the developments in the EU-10 in their early transition period. Capital spending in the second half of the 1990s in the EU-10 was about 3 percent on average. These countries began to dedicate more to capital spending (close to 4 percent of GDP) after joining the EU in 2004, which could be partly explained by the increased availability of EU funds. Having in mind the already high levels of public investment in most SEE countries and the limited fiscal space, the focus should be on assessing and improving the efficiency of public investment projects.

Graph II.12: **Government capital expenditure in the EU-10, as percent of GDP**



Source: Eurostat

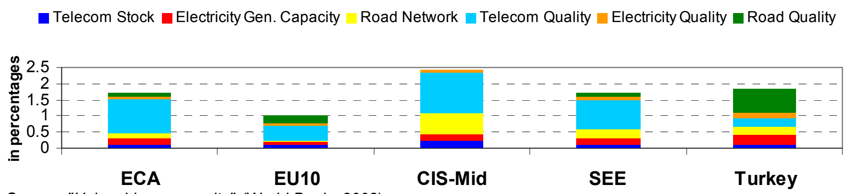
While the positive effects of public infrastructure on increasing the rate of return on private capital are clear, improving public infrastructure does not necessarily require public spending. This is especially important for most SEE economies where public investment has a significant share of GDP. Involvement of the private sector in public infrastructure projects through Public Private Partnerships (PPPs) can be an effective way to introduce private sector efficiency in service delivery to sectors traditionally dominated by the public sector and can limit the government burden on the economy (or overcome fiscal space constraints). PPPs increase the role of the private sector in the delivery of public services, such as water, electricity or telecommunications, and are expected to improve the quality and the affordability of access to services provided. There is evidence that investment under PPPs is positively associated with aggregate private investment. However, successful use of PPPs requires an enabling environment (political stability, rule of law etc.), and having an appropriate framework for PPPs would ensure the effectiveness of the private-public engagement.

II.6.2. The quality of infrastructure matters

The "Unleashing productivity" report (World Bank, 2008) finds that improving infrastructure quality is one of the most important factors for boosting productivity growth in the ECA region. The infrastructure stock, together with its quality, has the greatest impact on productivity. For example, the study shows that if infrastructure quality in the ECA region were raised to the level of the median industrial country; that would raise productivity growth in the ECA region by 1.25 percentage points. And in Croatia, the productivity impact of improving infrastructure exceeds that of improving financial depth. Not only the quality of infrastructure, but also the infrastructure stock in SEE is below levels in industrial countries and fast-growing regions such as East Asia .

Telecommunications quality has the greatest impact overall in the ECA region; in SEE even more so than in the EU-10. The two other measures of infrastructure quality in the above mentioned report are the quality of electricity and roads. The continuous improvements in the telecom sector in all countries and the shift to mobile services are likely to reduce the impact of telecom quality in the near future. Nonetheless, the importance of this component is large, and since telecom operators are privately owned throughout SEE, public policies can only have an indirect impact. On the contrary, electricity generation and transmission and road building is an activity where the state plays a predominant role currently. Hence, governments can reap the benefits from improved electricity and road quality through more public investment in these sectors as well as by increasing the efficiency of operations.

Graph II.II.13: **Impact of infrastructure improvements on productivity growth**



Source: "Unleashing prosperity" (World Bank, 2008)

II.6.3. The crowding-in and crowding-out effects in the case of Croatia and the former Yugoslav Republic of Macedonia

Public capital spending in Croatia as a share of GDP is relatively high compared to other European countries; it is more than three times higher than in the EU-15 and 40 percent higher than in the New Member States (NMS). In addition, the NMS had access to substantial grant financing for infrastructure from the EU, both from the pre-accession and the cohesion funds. The bulk of capital spending has gone to transport infrastructure (which is 2 percentage point of GDP higher than in comparator countries). Croatia doubled the length of its motorway network between 2001 and 2007 to over 1,100 kilometers, and now has a motorway network which is more developed than in some of the EU-15 countries, measured per area or per population. Croatia has 2.06 km of motorway roads per 100 km2 compared to 1.65 km in the EU-15 and 26km per 100,000 inhabitants compared to 14 km in the EU-15.

The decision to invest in the motorway network, however, was not always based on a sound cost-benefit analysis or economic justification: several studies concluded that the road network in the late 1990s provided sufficient capacity (with few exceptions) for actual and projected demand. Croatia's heavy investments in new motorways have been at the expense of maintaining the non-motorway network and have resulted in considerable financial obligations to service the debt needed to finance this investment.

While it is difficult to estimate what would have been the optimal level of investment in road infrastructure in Croatia, motorway investments in recent years may have been excessive, in terms of capacity and quality standards (see Louis Berger SA, 2002 and European Commission 2003). The most obvious and direct "crowding-out" effect has been on maintenance and rehabilitation of the existing road network. Opportunity costs were high in other areas, notably education. Looking ahead, the central challenge for Croatia in the transportation sector is to ensure fiscal sustainability of the system by adopting a more disciplined approach to the planning and prioritization of investments, and making adequate provision for maintenance of assets.

The former Yugoslav Republic of Macedonia, on the other hand, is among the countries with the lowest rates of public investment to GDP in the region (both SEE and CEE). The historically low public investment levels in the former Yugoslav of Macedonia are one of the determinants for the low level of private investment. General government capital expenditures averaged only 3.5 percent of GDP over the 2003-07 period, below the 4.5 percent of GDP average for the CEE economies. This has led to a significant deterioration in the quality of public assets and has prevented the country from catching up with more advanced transition economies both in terms of size and quality of public assets. The size of road and rail networks, while being denser compared to SEE countries, lags behind that in the NMS.

The different paths of Croatia and the former Yugoslav Republic of Macedonia have led to different perceptions of the role of infrastructure on business activity. Investment in transport infrastructure in Croatia had a positive impact on doing business. According to the Business Environment and Enterprise Performance Survey (BEEPS) of the EBRD and the World Bank, in 1999 (before the large motorway investment started), more than 40 percent of firms perceived the quality and efficiency of roads as bad, which was an even higher share than in the former Yugoslav Republic of Macedonia, where 'only' 27.4 percent of firms found road quality to be bad. Then in BEEPS 2002, just little over 10 percent of firms found transportation as a problem of doing business, and in 2005 this figure fell to less than 8 percent of Croatian firms. In the former Yugoslav Republic of Macedonia, on the contrary, 16 percent of firms in 2002 stated that transportation is a problem for doing business, and the number of firms having stating this problem rose to over 18 percent by 2005 (more than the SEE average of 16 percent).

The former Yugoslav Republic of Macedonia has underinvested in public infrastructure in general, while Croatia has overinvested in road infrastructure relative to other sectors (e.g. energy). On the whole, both countries have not fully taken into account the network character of public infrastructure, which has important consequences for the overall impact of public investment on private investment and on economic growth. Businesses normally depend on numerous public services (roads, airports, post, electricity etc.), and the efficiency of certain public infrastructure depends on the other public services. Constructing a state-of-the-art airport would not bring as much as value added if telecommunications services are rudimentary in the country and if power shortages are a daily experience.

II.7. CONCLUSIONS

Sustained economic growth requires substantial rates of investment. Fast growing economies invest a large share of the output in order to bring more resources to the production process. Investment is not only a direct booster to output, it also brings new, more productive, technologies and stimulates TFP growth.

Output growth in SEE in the post-conflict period in the 1990s was mostly driven by TFP. The improvements in TFP that came from the simple reallocation of resources through privatization have been partly exhausted, so TFP-led growth cannot be the single driver of growth in the future. The role of factor accumulation (capital and labour) will be crucial for accelerated growth. Moreover, increasing the quantity and quality of investment is instrumental for maintaining and accelerating TFP growth. Hence, achieving higher investment rates is an overarching objective and this poses an important challenge for future growth in the SEE economies. It would also allow for a better utilization of labour, solve some of the current social issues and improve the relatively low living standards.

Since the start of transition process, private investment rates in SEE, and its pace of growth, have been low. Despite recent notable increases of private investment in some SEE economies, growth in others has been slowing. At the same time, the structure of investment is not the most conducive to rapid growth in a global environment. More is spent on construction than on machinery and equipment, and only a quarter of total investment has gone to tradable sectors. R&D spending is very low, and even though insufficient data is available on spending on ICT, there is no evidence that SEE firms are investing massively in ICT either.

The recent developments in the financial sector in SEE have boosted capital formation. Firms in SEE relied excessively on own funds for financing investment. The recent sharp increases in credit to the private sector have helped finance more investment. Capital markets at this stage do not seem to be of strong relevance for investment, but as the markets continue to deepen, their role should rise. Most SEE economies are significant recipients of remittances, but there is insufficient data to assess whether remittances have an impact on private investment. In addition, the current international financial turmoil could strain the capacity of domestic banks and companies to access foreign savings.

Foreign investment has stimulated investment across the region; however, the countries have failed to attract as much FDI as many of the New Member States. And as privatization related FDI is now expected to dye out, there is no evidence yet of a material shift to greenfield investment, which could facilitate a move up the value chain, as witnessed in some of the new Member States. FDI contributes directly to capital formation, but also has positive spill-over effects on domestic firms.

It is very difficult to ensure sustained rapid growth without also keeping up sufficient rates of public investment. The study points to the large infrastructure deficiencies in the region compared to the EU-10 countries, despite the relatively higher public investment rates. Hence, improving the quality of public investment is a key issue for the region. The paths of Croatia and the former Yugoslav Republic of Macedonia point to the need to properly plan and implement public infrastructure projects in order to maximize the “crowding-in” effects and eliminate any negative (crowding-out) effects.

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Part III

Country Analysis

III. COUNTRY ANALYSIS

III.1. ALBANIA

General macroeconomic situation

Albania experienced a relatively strong economic performance in recent years, in spite of extensive shortages of power supply starting from end-2005. Economic growth remained above 5% in real terms, accelerating from 5.5% in 2006 to 6.0% in 2007, a year in which a continuous drought worsened a hydro-resources based power supply. A continuously strong increase in domestic demand was supported by a strong credit growth and limited price pressures.

In 2008 economic activity accelerated, possibly according to preliminary estimates to around 10% year-on-year in real terms during the third quarter, boosted by the continuation of large-scale roads construction. Industrial production also remained strong, gaining 37.3% year-on-year during the third quarter of 2008, on an acceleration of the manufacturing sector while the production of the mining sector decelerated strongly after a sharp increase (39.1% year-on-year) in the second quarter. Additionally, retail trade growth remained strong also in the third quarter (22% year-on-year), somewhat lower than in the first half of 2008, partly due to a base effect.

International transactions

External imbalances remained high during the first nine months of 2008. The current account deficit widened to 13% of GDP, up from 11% in 2007, mainly due a worsening of the services balance and a decline in remittances. The merchandise deficit continued to increase slightly but remained close to 27% of GDP as in 2007. Exports capacity improved somewhat with exports growth accelerating (to 22% year-on-year in the third quarter of 2008) and exceeding imports growth for the second consecutive quarter. The ratio of exports to GDP has increased gradually close to 11%, still far behind the ratio of imports to GDP (38%). The coverage of merchandise trade deficit from other current net inflows dropped close to 50%, down from 60% in 2007. Net inflows from services (consisting to a large extent of expenditures of visiting emigrants) contributed by less than 1% of GDP, despite resuming from net outflows in the first half of 2008. Net income inflows (mainly from investments of banks) remained close to 3% of GDP, while net current transfers, dominated by remittances inflows, continued to decline (to 11% of GDP, down from 13% in 2007).

On the financing side, net capital inflows remained relatively strong, covering fully the current account deficit and increasing slightly reserve assets. Net foreign direct investment (FDI) inflows stood above 5% of GDP in the third quarter of 2008, broadly stable from 2007, while traditionally volatile small-scale portfolio investments resulted in net outflows. Net inflows of other capital remained strong, above 4% of GDP compared to 3% in 2007, partly related to substituting remittances with various types of capital inflows.

External debt

The economy's gross external debt remained stable at a relatively low at 25% of GDP in 2008. Public external debt increased to 17% of GDP in 2008 from 15% a year earlier. The financial sector's external debt increased significantly to 5.9% of GDP in 2008, supported by a surge of non-residents' deposits. Corporate sector external debt fell below 5% of GDP, partly guaranteed by the government.

Labour market

Labour market conditions improved in 2008 as employment grew by 3.6% after having remained unchanged during the last few years. The unemployment rate fell to 12.6%, the lowest level of recent years. Wage growth moderated, growing by 1.2% year-on-year during the third quarter of 2008, compared to 17% for the whole year of 2007, related to the introduction of reference wages in June 2007. Public sector wages remained broadly at the level of the third quarter of 2007 (increasing by 1.2% year-on-year in the third quarter of 2008).

Prices

Consumer price inflation had remained relatively contained in 2006–2007, leaving yearly average inflation below 3%, within the range of the central bank inflation target (3% +/-1 percentage point). In August 2007 inflation accelerated to above 4% y-o-y mainly due to a strong global increase in food and energy prices. While price pressures declined somewhat at end-2007, they resumed in March 2008 (year-on-year inflation 4.2% in April 2008), after an increase in electricity tariffs (by 18% on average). Thereafter inflation eased to 3% year-on-year during the third quarter of 2008. The drop of inflation resulted mainly from a base effect: in August 2007, food prices had surged due to a severe drought that affected vegetables prices, and due to global price developments that raised bread and cereals prices. Overall, domestic demand induced price pressures remained limited despite a relatively strong credit growth.

Monetary policy

Monetary policy had tightened somewhat in 2006–2007 in response to strong domestic demand and credit growth. The central bank started to raise the key monetary policy interest rate in July 2006, reaching stepwise 6.25% in end-2007 (a cumulative rise by 1.25 percentage points). Retail interest rates increased correspondingly, while the spread between the lek and the euro interest rates decreased. Increasing interest rates favoured deposits growth, contributing to money supply (monetary aggregate M3 growth 15.5% y-o-y in 2007). The share of resident's deposits in foreign currency increased to 76% of total residents' deposits (third quarter of 2008), in addition to the strong increase in non-residents' deposits.

In 2008 the central bank maintained the key monetary policy rate at 6.25%. Risks to price stability were contained, the average consumer price inflation (as of 12-months moving average) remained within the target range of 3+/-1 percentage point. Economic activity continued to be fuelled by fast credit growth, with the private sector credit growth accelerating to 45% (year-on-year) during the third quarter of 2008, after some deceleration earlier in the year.

The recent strong growth of private sector borrowing started to slow down already in 2006, supported by central bank's measures. Credit growth still remained high, in case of loans to the corporate sector 43.3% and loans to households 47.6% (y-o-y, June 2008). The share of households borrowing increased to 36% of total private sector borrowing (up from 31.5% in end-2005).

Global financial market turbulences have not so far adversely affected the Albanian economy. The volatility of the national currency, the lek, remained rather limited vis-à-vis the euro during 2006–2007. Compared to end-2005, the lek appreciated slightly (1%) by end-August 2008, with a period of somewhat more pronounced depreciation (up to 3.3%) in the first half of 2007.

In 2008, the central bank maintained the key monetary policy rate at 6.25%. Risks to price stability remained contained, with the average consumer price inflation for 2008 remaining within the range of inflation target of 3+/-1 percentage point.

The financial sector remained sound, with profitability increasing after a drop in the first quarter of 2008, and with capital adequacy well above the minimum ratio. Loan quality deteriorated somewhat.

Financial stimulation of the economy remained strong, with private sector credit growth of 41% (year-on-year) in November 2008, after a temporary acceleration to 45% in June-July. The growth of credit to the corporate sector accelerated somewhat since June 2008 after a gradual decline since 2006. The growth of credit to households continued to decline since end-2007, dropping to 36% (year-on-year) in November 2008, compared to 44% in case of the corporate sector.

Money supply also remained strong despite some small-scale volatility in deposits. M3 growth decelerated below 12% (year-on-year) in November after some acceleration in the third quarter of 2008. Foreign currency deposits continued to account for more than 30% of the broad money supply (M3) despite a slight reduction of the deposits in October and November compared to preceding months.

On the foreign exchange market the lek remained broadly stable vis-à-vis the euro standing at 122.8 ALL/EUR on average in the fourth quarter of 2008. In the beginning of January 2009 the exchange rate depreciated (up to 1.3% compared to end-December) close to the recent peak in February 2008.

Fiscal developments

Tax revenue collection improved in recent years, resulting in an increase in budget revenues (25.7% of GDP in 2007). A major change in tax policy, the introduction of a flat personal income tax of 10% (since July 2007), together with strengthened management of public finances, increased respective tax revenues. In 2007, budget expenditures were additionally expanded by a subsidy of 0.5% of GDP to the state-owned power plant.

For 2008, the approved budget initially foresaw a high increase in public infrastructure investment, and a subsequent rise of the general government deficit up to a level of 7.9% of GDP. However, following consultations with the IMF in the context of the current programme's review, it was agreed in early 2008 to cut down expenditure (mainly capital expenditure) and limit the general government deficit to 5.2% of GDP. The supplementary budget projects revenues of 28.2% of GDP (up from 26.4% from the previous projection) and total budget expenditures of 33.4% of GDP (down from 34.3%). The 2008 budget implementation followed broadly the plan, reaching 98% of 10-months planned tax revenue collection. The 10-months expenditure plan was met by 94%, with capital expenditures lagging behind projections. In the first 10-months the budget deficit remained below 2% of GDP, far below the projected 5.2%.

The 2009 budget is still expansionary despite a projected reduction of the deficit to 4.2% of GDP. The budget relies on revenue projections that are highly optimistic in the context of the global economic slowdown and may therefore result in a higher deficit. The projected structure of expenditures is growth supportive, maintaining current expenditures below 24% of GDP and reserving 7.6% of GDP on capital expenditures

Structural reforms

The privatisation of large-scale companies progressed. In 2007, the privatisation of the incumbent telecom operator Albtelecom was completed, after several years of delay. In May 2008, the sale contract of 85% stake in the oil refinery ARMO was concluded. Additionally, the government opened an international tender for the privatisation of 51–76% of the shares of the distribution arm of KECH, the state-owned power utility. The government also continued the restructuring of the utility, including increasing electricity tariffs closer to the cost-recovery levels. In parallel, many concessions have been granted for small-scale power plants.

The government revised in 2007 the regulatory framework for the business environment, launching more efficient business registration procedures (opening one-stop-shops) and abolishing several licensing requirements. Regarding income taxation, a flat income tax of 10% was introduced for individuals (effective from July 2007) and for the corporate sector (effective from January 2008). The central bank increased transparency of the financial market, opening a credit registry in January 2008. The government continued with the strengthening of administrative capacity, including in the management of public finances. More efficient tax collection and public investment procedures were introduced.

Table III.III.1:
Albania - Main economic trends

		2002	2003	2004	2005	2006	2007	Q3 2008
Gross domestic product	Ann. % ch	4.2	5.8	5.7	5.7	5.5	6.0	:
Private consumption	Ann. % ch	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a
Gross fixed capital formation	Ann. % ch	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a
Unemployment	%	16.0	15.2	14.7	14.3	13.9	13.4	12.6
Employment	Ann. % ch	-14.1	0.9	-0.4	0.9	0.2	0.2	3.6
Wages	Ann. % ch	14.2	13.8	15.3	9.9	7.5	17.1	1.2
Current account balance	% of GDP	-9.5	-7.0	-5.8	-8.9	-6.5	-10.5	-13.2
Direct investment (FDI, net)	% of GDP	3.0	3.1	4.5	3.2	3.4	5.8	5.7
CPI	Ann. % ch	5.3	2.4	2.9	2.4	2.4	2.9	3.0
Interest rate (3 months)	% p.a.	12.50	8.87	6.78	5.55	5.49	5.92	6.26
Bond yield	% p.a.	n.a.	11.40	9.92	8.22	7.31	:	:
Stock markets	Index	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a
Exchange rate LEK/EUR	Ann. avg	132.40	136.80	127.17	123.73	122.76	123.31	122,39*
Change real eff. exchange rate (CPI based)	% eop	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a
General government balance	% of GDP	-6.1	-4.9	-5.1	-3.5	-3.3	-3.5	:
General government debt	% of GDP	62.9	61.7	56.6	57.4	55.5	53.8	:

* *Year 2008*

Sources: Reuters/Ecowin, national sources

III.2. BOSNIA AND HERZEGOVINA

General macroeconomic situation

In 2007, real GDP growth remained high at 6.8%, close to the 6.7% recorded in 2006, and was driven by a strong increase in domestic demand, as evidenced inter alia by a widening of the current account deficit and a pick-up in core inflation (excluding food and energy prices). The acceleration of domestic lending together with fiscal relaxation fuelled economic growth by stimulating both consumption and investment. Due to some unfavourable domestic and external conditions – a drought and the rise of international energy and food prices coupled with a decline in the price of aluminium – gross value added was almost flat in real terms in the agriculture and utilities sectors, in contrast with double-digit growth rates recorded in financial intermediation, construction and manufacturing. The growth of industrial production decelerated to 8.6% in the Federation of Bosnia and Herzegovina (FBiH) and declined significantly to 1.4% in the Republika Srpska (RS) after a record 19.1% in 2006. The slowdown in the RS was caused primarily by an overhaul of production capacities in the mining and oil industry and a declining output in the utilities sector, while the manufacturing sector advanced by 4.1%. Also in the FBiH, utilities underperformed in 2007, but the strong output growth rates of 11.7% in the manufacturing sector made up for the decline.

While in the first half of 2008 growth continued to be strong, though not reaching previous years' levels, the global economic slowdown started to reveal an impact on BiH towards the end of the year. The metal and automobile industries, the country's most important export sectors, announced output cuts and lay-offs in the fourth quarter 2008. Also the wood processing industry and the service sector reported a worsening of performance. However, the annual growth rate of industrial production was buoyant and stood at 16.8% in the RS and at 7.9% in the FBiH. In the FBiH, energy, capital goods and non-durable consumer goods contributed positively, while a decline was observed for intermediate goods and durable consumer goods. In the RS the production of both durable and non-durable consumer goods, energy and intermediate goods increased, while it decreased in capital goods.

International transactions

In 2007 the trade deficit widened to 37.4% of GDP as imports rose by around 19% year-on-year outperforming the 15% growth of exports. As the positive balances of services, income and current transfers declined as a percentage of GDP, the current account deficit widened from 8.4% of GDP in 2006 to 12.7% of GDP in 2007. It was fully financed by net FDI as the large privatisations of Telekom Srpska and the RS refineries contributed to a surge in FDI to 13.4% of GDP.

During the first three quarters of 2008 the current account deficit further increased by 48.3% year-on-year. This deterioration was caused by an increasing trade deficit which persistently deteriorated during the first ten months of 2008 due to import growth being higher than export growth. Improving income and current transfer accounts partially offset this effect. The trade balance showed an interesting development in November and December when its first annual improvements in two years were registered: The monthly trade deficit declined by 10.6% year-on-year in November and by 7.4% in December. This is due to a decline in imports (by 5.2% year-on-year in November and 5.7% in December), while exports still increased by 2.0% in November before falling by a slight 2.7% in December. The decline in imports is mainly the result of falling crude oil prices, while the restarting of production in one of the major oil refineries in BiH also contributed to this development. Regardless of these very recent developments, the annual 2008 trade deficit increased by 16.4% compared to 2007, reaching an estimated 40% of GDP.

Net FDI declined sharply by 57% in 2008 compared to the previous year. However, this is to a large extent the result of the high basis and may not be interpreted as a withdrawal of investors from BiH. 2007 was an exceptional year when FDI was roughly three times higher than in the three preceding years, triggered by a number of large privatisation deals. In 2008 the volume of FDI was more or less in line with the years 2004-2006.

Trade liberalisation continued as Bosnia and Herzegovina signed and ratified the CEFTA agreement in 2007, continued its negotiations for WTO accession and signed a Stabilisation and Association Agreement with the EU in June 2008.

External debt

External public debt continued to decline in 2007 and reached 18.3% of GDP at the end of the year. This rather low level should be interpreted with care, given the high level of contingent liabilities that could add to public debt. The stock of public foreign debt further declined during the first half of 2008. Total external debt is estimated at below 50% of GDP in 2007, but no official data is available for this indicator.

Due to strong capital inflows, official foreign exchange reserves increased by around 23% in 2007, thus covering 5.4 months of imports. In the course of 2008 (November data), however, they declined by 7% compared to their end-2007 level, thus covering 4.5 months of import.

Labour market

Although the number of employed persons increased in the whole country in 2007, (by 6.2% in the FBiH, 2.4% in the RS) the registered unemployment rate remained almost unchanged averaging about 44%. It was mainly due to the increase in the number of registered unemployed in the FBiH, also as a result of the Law on Entitlements for Demobilised Combatants and their Families, which in addition introduced further fiscal strains. However, labour market dynamics have improved since 2007: The consolidated national official rate of registered unemployment decreased from 42.9% in December 2007 to 40.3% in October 2008. Employment increased by 4.1% in the first ten months of 2008 as compared to the same period 2007. Unemployment continues to be higher in the FBiH than in the RS.

The levels of registered employment and unemployment differ significantly from the results of the labour force survey (LFS). The LFS of May 2008 shows a major reduction of the unemployment rate to 23.4% of the labour force from 29% a year earlier. It also found that labour force participation remained very low at about 44% of the total working age population. The labour market performance of the two entities is slightly divergent: the economic activity rate stood at 47% in the RS (against 42.4% in the FBiH), while unemployment declined to 20.5% (against 25% in the FBiH).

Wages have grown rapidly in 2008. In June 2008, the new public sector wage legislation of the RS translated into a 31.5% year-on-year increase of the average net salary in the entity. It represented an almost threefold acceleration against January. Mainly due to this effect, nominal net wages in the RS were 30.1% higher in November 2008 than in the same month of the previous year. In the FBiH they increased by 11.1%. Gross wages increased by roughly the same percentages in both entities. Due to the more rapid wage growth in the RS, average wages are now slightly higher in this entity than in the FBiH (by 2.4% in net and by 4.6% in gross terms, November data).

Prices

The average annual inflation rate dropped down to 1.5% in 2007 from 6.1% in 2006 as the effects of the VAT introduction in January 2006 dissipated. However, after very low and even sometimes negative rates in the first half of 2007, the monthly inflation rate started to pick up sharply in the second half of 2007, and continued this increase until July 2008 when it reached 9.9% year-on-year. Afterwards, the rates declined down to 3.8% in December 2008. Both trends were almost entirely driven by international energy and food price developments. Overall, the average inflation rate in 2008 stood at 7.4% in BiH. The average price increase was slightly higher in the FBiH where it reached 7.7% in 2008, compared with 7.2% in the RS.

Monetary policy

The monetary policy of the Central Bank of Bosnia and Herzegovina (CBBH) is conducted under the framework of a currency board arrangement with the euro as the anchor currency which has functioned smoothly since 1997. After years of high growth (23.2% in 2007), reserve money declined in 2008 by 9.5% (November data). This development accelerated towards the end of the year. Nevertheless, the coverage by foreign exchange reserves was ample and stood at 110.5% in November 2008. This ratio has not varied much since 2006. The growth of money supply measured both in M1 and M2 significantly declined in October and November 2008. The annual growth of broad money (M2) fell sharply from around 22% at the end of 2007 to only 3.2% in November 2008, mainly due to a slowdown in the growth of demand deposits which turned even negative in the last quarter.

The annual growth of credit accelerated from 23.4% at the end of 2006 to 28.5% at the end of 2007. In an attempt to slow down this growth the CBBH raised the reserve requirements rate from 15% to 18% as of January 2008. In October, however, the international financial crisis led to tensions in the Bosnian financial market causing a withdrawal of deposits by the population and liquidity shortages in the banking system. Since then, the CBBH and the government have introduced a number of measures in order to strengthen and restore confidence in the Bosnian currency board arrangement and national financial markets. With the aim of safeguarding the liquidity of the banking system and stimulating credit activities, the CBBH provided cash to the banking system and lowered the minimum reserve requirement rate again from 18% to 14% in October. Furthermore, as of November all new credit lines withdrawn from abroad by commercial banks do not enter into the basis for required reserves calculation and, as of January 2009, the required reserve rate on term deposits with a remaining maturity of more than one year is lowered to 10% while it remains at 14% for deposits with a maturity of below one year. Despite these developments, the annual rate of credit expansion is still buoyant and stood at 24.8% in November, but it had come down five percentage points since the middle of the year. In the meantime, the government initiated an increase of the deposit guarantee from around EUR 3,500 to more than EUR 10,000.

Profitability and liquidity indicators of the banking sector somehow deteriorated in the first three quarters of 2008. However, overall they still reveal a relatively favourable position, but it is not yet clear to what extent the global financial crisis may have an impact on the soundness of the Bosnian financial sector.

Fiscal developments

After several years of discussions, the National Fiscal Council was established and convened in Sarajevo on 11 September 2008. The Council is meant to coordinate fiscal policy between the different state levels with the aim of securing macroeconomic and fiscal sustainability in BiH.

The large increase in public spending initiated in 2006 continued in 2007 and 2008, accompanied by a deterioration in the quality of public spending. The good performance of budget revenues growing by around 15% from 2006 to 2007 could not prevent a worsening of the fiscal position in 2007 after expenditures grew by almost 19% or 2.1% of GDP over the period. As a result, the surplus of 2.9% of GDP recorded in 2006 declined to 1.3% in 2007. Due to a continued rise in expenditures reaching almost 41% of GDP in 2008 (up from 37% in 2005), especially on wages and social benefits, in combination with decelerating indirect revenues following trade liberalisation under the Stabilisation and Association Agreement (SAA) and increasing VAT refunds, general government finances are expected to turn into a deficit of around 2% of GDP in 2008. Government Finance Statistics revealed that collected revenues increased by 15% year-on-year during the first three quarters of 2008 but were outpaced by the growth in expenditures by 28%.

Since the State Parliament budget committee proposed certain amendments to the draft 2009 budget for the state institutions in order to harmonise it with a decision of the National Fiscal Council limiting its annual increase to 12%, it could only be adopted in January 2009. The Council of Ministers had to define provisional financing for the first quarter 2009, amounting to a quarter of the 2008 budget.

The RS draft 2009 budget was discussed in the entity's assembly on 22 and 23 December 2008. It foresees a reduction of public expenditures to below 40% of GDP. The FBiH parliament adopted the draft 2009 budget at the end of December which is to be revised in April based on revenue and expenditure figures for the first quarter of 2009. Both entity budgets are in line with the provisions of the Fiscal Council of a maximum increase of 6% as compared to 2008.

Structural reforms

Since 2007, the progress with structural reforms has been uneven between the two entities and the various reform areas. In the FBiH, the privatisation process made only marginal progress in the previous two years. A new privatisation strategy which aims at selling the two telecoms and other strategic companies was approved in 2008. In the RS, the privatisation process advanced well in 2007, when large privatisations in the telecom and oil industry were completed. Until September 2008, the authorities succeeded in selling another 13 companies. More than 100 SOEs are in the liquidation process. In both entities, utilities have not been earmarked for sale yet. The unbundling of the electricity companies was finalised in the RS, while the FBiH still needs to proceed with the incorporation phase. Moreover, the FBiH plans to merge the power utility company with the coal mines and cover a portion of their current debts, which may further disrupt the unbundling process and restructuring.

The business environment was further improved. The implementation of a new company registration system in courts was completed. The RS adopted amendments to improve bankruptcy procedures and introduced changes to the corporate law which are under adoption. The so-called "guillotine process" meant to reduce red-tape was completed. The FBiH adopted the reform of direct taxation, changes in the profit tax legislation taking place as of January 2008 and in the personal income tax legislation as of January 2009. After having implemented some parametric reforms to the pension systems, the two entities are considering the introduction of additional pillars based on capitalisation of contributions.

Overall, according to the World Bank's 2009 "Doing Business" report, and despite some advancement of structural reforms, in 2008 the country remained behind its peers in the region.

Table III.III.2:
Bosnia and Herzegovina - Main economic trends

		2002	2003	2004	2005	2006	2007	Q3 2008
Gross domestic product	Ann. % ch	5.5	3.0	6.3	3.9	6.7	6.8	n.a
Private consumption	Ann. % ch	n.a.	n.a.	n.a.	6.2	8.3	13.4	:
Gross fixed capital formation	Ann. % ch	n.a.	n.a.	n.a.	18.5	-7.6	37.0	:
Unemployment	%	40.9	42.0	43.1	44.7	44.2	42.9	40.5
Employment	Ann. % ch	1.9	-0.6	0.8	0.8	2.3	4.4	4.4
Wages	Ann. % ch	1.4	8.4	4.3	6.1	9.6	9.8	18.5
Current account balance	% of GDP	-19.1	-19.4	-16.3	-17.3	-7.8	-12.6	:
Direct investment (FDI, net)	% of GDP	4.3	4.6	7.0	5.7	5.8	13.8	:
CPI	Ann. % ch	0.2	0.6	0.5	4.3	6.1	1.5	7.4**
Interest rate (3 months)	% p.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a
Bond yield	% p.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a
Stock markets	Index	n.a.	n.a.	n.a.	n.a.	4,175	7,532	3,832**
Exchange rate BAM/EUR	Ann. avg	1.96	1.96	1.94	1.95	1.95	1.94	1.94**
Change real eff. exchange rate (CPI based)	% eop	-1.0	-1.2	0.3	0.0	-1.9	0.7	0.1
General government balance	% of GDP	-0.1	0.7	1.6	2.4	2.9	1.3	-2.0***
General government debt(*)	% of GDP	33.4	27.7	25.5	25.6	21.3	18.5	16.0***

(*) Includes only external public debt (**) Year 2008

(***) Authorities' estimate in the 2008 EFP; in case of the balance year 2008 data

Sources: Reuters/Ecowin, national sources

III.3. CROATIA

General macroeconomic situation

The global financial crisis and lower foreign demand from Croatia's main trading partners in the EU have started to affect the Croatian economy. In the first three months of 2008, real GDP growth slowed considerably to 3% on average, down from 6.2% during the same period a year before, and the economic performance deteriorated further in the last quarter of 2008.

Over recent years, the economy exhibited a relatively strong growth performance. GDP growth accelerated to 5.6% in 2007, the highest rate since 2002. Growth remained largely driven by domestic demand. In 2007, household consumption grew 6.2%, and continued to be fuelled by strong credit growth and significant debt repayments to pensioners, which amounted to around 1.2% of GDP in 2007. Public consumption growth accelerated to 3.4%, also reflecting a surge in spending prior to the general elections in November 2007. At the same time, the growth of investment decelerated, but still remained robust at 6.5%. As in previous years, the contribution of net exports to GDP growth remained negative (-0.8 percentage points) in 2007, as imports grew stronger than exports. On the supply side, a strong growth of some services, in particular financial intermediation, retail trade and tourism contributed significantly to the growth acceleration. Since the last quarter of 2007, economic growth has continued to decelerate, as some one-off domestic factors which fuelled demand in 2007 eased and the international environment became less benign.

International transactions

The current account deficit widened significantly from 7.9% of GDP in 2006 to 8.7% in 2007, and to close to 11% in the four quarters to September 2008, notably resulting from higher world energy and other commodity prices and a continued relatively strong import growth. More recently, a lower growth of exports, reflecting a decline in foreign demand, as well as higher net factor payments also contributed to the worsening of the current account. The composition of the current account has not changed compared to previous years. The merchandise trade deficit remained high and increased, to 25.2% of GDP in 2007, and further to 26.6% in the twelve months to September 2008. The trade gap was again partly compensated for by the traditional surplus in the trade with services (16.8% of GDP), mainly resulting from tourism revenues, which represent around 40% of total exports. Net FDI inflows grew by around 33% in 2007 to 9.1% of GDP, from 7.6% in 2006, more than offsetting the current account deficit. FDI flows were largely driven by the recapitalisation of banks, while Greenfield investments remained relatively low. In the twelve months to September 2008, net FDI inflows however dropped to 7% of GDP.

External debt

The stock of external gross debt continued to increase markedly by 12.5% in 2007 and 13% in the first nine months of 2008, but the share of short-term debt remained relatively low at 12.7% in September 2008. The external debt to GDP ratio climbed to 87.8% by end-2007, up from 85.5% at end-2006. The further increase in external debt was particularly driven by strong foreign borrowing by the corporate sector. At the same time, domestic banks reduced their outstanding external obligations in 2007, presumably in response to central bank measures to discourage their foreign borrowing operations. However, the surge in the corporate sectors' external debt reflects a situation whereby domestic banks increasingly referred their corporate clients directly to parent banks abroad, thus partly circumventing the central bank's administrative measures.

Labour market

The recent slowdown in economic activity has not yet impacted on the labour market which still exhibits relatively favourable trends. The officially registered unemployment rate continued to decline, to 13.2% in November, which was one percentage point lower than in the same month a year ago. Total employment growth slightly decelerated to 0.3% year-on-year in November, bringing the average employment growth in the first eleven months to 1%. However, official employment data often underestimate labour market dynamics and are often subject to revisions. Data from the labour force survey confirm relatively favourable trends for the first half of 2008. It reported a decline in the unemployment rate to around 9%, against 10.1% in the first half of 2007, and an employment growth of 1.6% over the same period.

Prices

Average annual inflation decreased slightly in 2007 to 2.9%, down from 3.2% a year before. While inflation remained low throughout the first half of the year, it significantly accelerated since mid-2007 to 8.4% year-on-year in July 2008. This acceleration was mainly due to supply shocks which led to considerable price increases of agricultural, food and energy products. Moreover, hikes in administered utility prices, most of which are controlled by local governments, also added to higher inflation. Since July 2008, end-of-period inflation has come down (to as low as 2.9% in December), driven by lower energy and commodity prices and as a result of slowing demand pressures.

Monetary policy

Monetary policy continued to be geared at stabilising inflation expectations through a tightly managed float. Under the conditions of a highly euroised financial system, exchange rate stabilisation through foreign exchange interventions remained an important objective of monetary policy. The CNB also continued to rely on administrative and prudential measures in order to contain strong capital inflows, in particular direct borrowing from abroad by domestic banks, and rapid credit growth. Restrictive measures introduced in 2007 were partly adjusted in 2008 with a view to more effectively raise domestic banks' costs to borrow abroad and to lend domestically. Marginal reserve requirements on banks' foreign borrowing were removed in the second half of 2008 when tighter external financing constraints as a result of the global financial crisis became evident. Partly as a result of tight monetary policy and the measures taken by the CNB, the growth of domestic credit to the private sector decelerated from around 23% in 2006 to 15% in 2007 and further to around 11% in 2008. The growth of lending in 2007 to the non-financial corporate sector decelerated more markedly than lending to private households, but reaccelerated in 2008. Moreover, some corporations turned to direct borrowing from abroad, thereby circumventing domestic borrowing restrictions.

Despite a continued surge in capital inflows, the nominal exchange rate of the Kuna vis-à-vis the euro has been kept rather stable. In 2007 and 2008, the average monthly rate fluctuated within a very small range between 7.12 and 7.40 kuna and slightly appreciated by 1.7% over this period. In order to lower appreciation pressures on the kuna, the CNB intervened five times in the foreign exchange market in 2007 and early 2008, purchasing euro for a total amount of around EUR 850 million. During the last quarter of 2008, the kuna came occasionally under depreciation pressures, to which the CNB reacted by selling EUR 270 million in the market, thereby confirming to be ready to promptly react to foreign exchange speculations. In a further step to ease depreciation pressures in early 2009, the central bank relaxed reserve requirements in foreign exchange. Official foreign reserve accumulation continued and the level of reserves reached EUR 9.8 billion at end-2008, compared to EUR 8.8 billion a year before. This represents a comfortable level of around 5 months of imports of goods and services.

Fiscal developments

Fiscal developments in 2007 benefited from a growing economy and strong revenues. As a result, the general government deficit was reduced as planned, to 1.6% of GDP, down from 2.5% in 2006 (in ESA 95 terms). A revised budget 2008 was adopted in July and foresees a slightly lower than originally planned budget deficit (1.3% instead of 1.6% of GDP), which is however mainly the result of an ad-hoc exclusion of the public motorway company from the general government accounts. As in previous years, the revised budget foresees higher than originally projected revenues which are used to repay health sector arrears, to compensate private households for higher energy prices, and to provide additional funds for regional development as well as for science and education. Despite a slowing economy, actual budget performance in 2008 was still marked by a robust performance of revenues, as suggested by available data for the first eight months. Consolidated central government revenues rose 8.9% year-on-year, with particularly strong increases in VAT, income and property taxes. Spending rose by 8.5% and subsidies to the corporate sector, mainly provided to loss-making companies, increased by almost 20%. Although budget execution in the first eight months have been in line with budget plans, the recent economic slowdown as well as the fact that a number of operations are still kept outside the budget, may actually lead to a higher than the targeted 1.3% of GDP deficit for the consolidated general government in 2008. The budget framework for 2009 was voted by Parliament on 15 December and foresees a reduction of the general government deficit to 0.9% of GDP. The deficit is slightly higher than originally envisaged in the medium-term budget framework of the Pre-Accession Economic Programme. It also contrasts with earlier intentions expressed by the Prime Minister and the Minister of Finance to balance the budget to reduce financing requirements in 2009.

Weak fiscal transparency remains an issue of concern. Fiscal accounts do not include a number of off-budget operations, such as debt repayments to pensioners (1.2% of GDP in 2007) and quasi-fiscal activities of the State Development Bank (HBOR). Therefore, the actual fiscal policy stance has been more expansionary than suggested by headline budget figures. The stock of general government debt stood at 34.5% of GDP in September 2008, down from 38% in the same month in 2007. However, adjustments for the stock of issued state guarantees and the debt of the State Development Bank (HBOR) would raise the stock of debt by around 10 percentage points of GDP.

Structural reforms

Structural reform progress has been uneven and the pace of reforms has somewhat slowed before the general elections in November 2007 and during and after the formation of a new government in early 2008. Nonetheless, over recent years, some important initial steps and preparatory measures have been taken to reform health care financing, welfare spending and the pension system. However, those measures were not followed up by more comprehensive reforms, supportive of ensuring the long-term sustainability of public finance. Also, some earlier parametric reforms to the pension system were reversed.

Steps have been taken in 2007 and 2008 to improve the overall business environment, in particular in the area of company registration. A project of a "regulatory guillotine" was launched to reduce significantly the burden of unnecessary legislation, but its implementation has been slow.

The privatisation of the country's oil and telecommunication incumbents advanced in 2007, following earlier delays, and the restructuring and unbundling of the loss-making railway carrier continued. Moreover, the government sold two loss-making steel mills and an aluminium company to private investors. However, the broader privatisation process has been rather uneven and hampered by legal problems, institutional weakness and – in a few cases - unrealistic sale conditions. A new institutional setting for privatisation has been in preparation for some time and may eventually give a new impetus to the process. The restructuring and privatisation of the large shipbuilding sector has made only limited progress. Shipbuilding continued to be a large recipient of state aid. An acceptable restructuring plan for the sector is a key element of the accession negotiations with the EU.

Table III.III.3:
Croatia - Main economic trends

		2002	2003	2004	2005	2006	2007	Q3 2008
Gross domestic product	Ann. % ch	5.6	5.3	4.3	4.3	4.8	5.6	1.6
Private consumption	Ann. % ch	7.7	4.6	4.8	3.4	3.5	6.2	0.4
Gross fixed capital formation	Ann. % ch	13.9	24.7	5.0	4.9	10.9	6.5	6.6
Unemployment	%	14.8	14.3	13.8	12.7	11.1	9.6	12.4
Employment	Ann. % ch	0.8	2.5	1.2	0.8	3.3	3.3	0.7
Wages	Ann. % ch	6.0	4.8	6.4	4.4	6.2	6.2	7.4
Current account balance	% of GDP	-8.7	-7.4	-5.2	-6.4	-7.9	-8.7	-10.9
Direct investment (FDI, net)	% of GDP	2.3	6.4	2.1	3.9	7.5	9.3	7.0
CPI	Ann. % ch	1.7	1.8	2.0	3.3	3.2	2.9	7.4
Interest rate (3 months)	% p.a.	4.63	5.42	7.32	6.21	4.46	5.66	7.19*
Bond yield	% p.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a
Stock markets	Index	1,167	1,129	1,284	1,920	2,771	4,673	3,299*
Exchange rate HRK/EUR	Ann. avg	7.42	7.57	7.50	7.39	7.30	7.33	7.22*
Change real eff. exchange rate (CPI based)	% eop	98.2	95.7	92.6	90.6	88.9	86.5	80.3
General government balance	% of GDP	-4.1	-5.5	-4.1	-3.8	-2.2	-1.8	:
General government debt	% of GDP	40.0	40.9	43.3	43.7	40.8	38.7	:

* *Year 2008*

Sources: Reuters/Ecowin, national sources

III.4. THE FORMER YUGOSLAV REPUBLIC OF MACEDONIA

General macroeconomic situation

Economic activity was rather strong in 2007 and the first 3 quarters of 2008, with GDP growth of nearly 6% during that period, compared to annual growth rates of about 4% in 2004-2006. Main contributors to this growth acceleration were private consumption and investment. Exports performed very well in 2007 and the first half of 2008, benefitting from strong global demand. However, due to the high import content of exports and investment, imports increased even more. As a result of strong imports of machinery, but also higher costs of importing energy, the current account deteriorated in the first three quarters of 2008 to a deficit of nearly 13% of GDP. When looking at the various sectors, wholesale and retail trade as well as transport were the sectors with the highest contribution to GDP growth, while the country's largest sector, manufacturing accounting for some 22% of GDP, contributed less than one percentage point to overall growth. International forecasts, such as the IMF's, expect annual output growth at 5½% in 2008. However, in 2009, sharply decelerating global demand will probably bring GDP growth to lower levels.

Industrial production, which accounts for some 20% of total value added, rose by 11% in the first eleven months of 2008, compared to 3.8% in 2007. However, towards the end of 2008, output started to contract sharply, declining by nearly 10% in October and 3% in November. In the past, this indicator used to fluctuate strongly, reflecting the closing and re-opening of a few, but relatively large production sites.

International transactions

The country's external balances deteriorated sharply during the first three quarters of 2008, reflecting strong import growth, while the performance of exports and capital inflows remained rather stable. In 2006 and most of 2007, external accounts had remained close to balance, benefitting from strong export growth and high private transfers in the form of workers remittances and cash exchanges at exchange offices. However, towards the end of 2007 and during the first half of 2008, imports rose sharply, while the inflow of private and public transfers decelerated. As a result, the trade deficit rose to nearly 27 % of GDP by the end of the third quarter of 2008, compared to 16% of GDP a year before. This resulted in a rapid increase in the current account deficit from 3% of GDP end 2007 to some 13% of GDP by the end of second quarter. In the third quarter of 2008, both, import and export remained constant as a share of GDP, reflecting declining energy prices but also a significant slowdown in external demand. In terms of trade composition, the most important export products are iron, textiles and tobacco. On the import side, oil products, motor vehicles and electricity are the most important items. The EU-27 is by far the country's most important trading partner, accounting for some 60% of exports and nearly 50% of imports. Another 36% of exports are sold in the Western Balkan countries.

An interesting feature during recent years has been the strong increase in private capital inflows in the form of workers remittances or cash exchanges, increasing from 13% of GDP in 2004 to 17% in 2005 and 18% of GDP in 2006 and 2007. Foreign direct investment fluctuated strongly in recent years, often reflecting a few, but significant privatisation projects. In 2006, FDI inflows had increased from 1.6% of GDP in 2005 to 6.8%, mainly as a result of the privatisation of the energy distribution company to a foreign investor. In 2007, FDI inflows returned to a level of 4.3%, but rose again to 8% of GDP during the first three quarters of 2008, mainly due to investments of foreign banks in the country's banking sector.

In November 2008, official reserve assets of the National Bank stood at a level of EUR 1.7 billion, equivalent to some 3 months of expected imports of goods and services.

External debt

Gross external debt remained rather constant (at some 48-49% of GDP) during 2007, and rose slightly to 51% of GDP by September 2008. During this period, public debt declined markedly (from 24% of GDP in December 2006 to 17% of GDP in September 2008), while private external debt rose significantly (from 24% in December 2006 to 35% of GDP in September 2008). The main factors for the decline in public external debt were early buy-backs, while increased foreign borrowing by private enterprises was the main driving force for the increased foreign debt. About two thirds of this private non-financial debt is short-term. In December, the credit rating agency Standard & Poors downgraded the country's foreign debt outlook from stable to negative, responding to the recent deterioration of external liquidity. Fitch's rating so far has remained at BB/positive.

Labour market

The labour market situation continues to be characterised by high but slowly declining unemployment. According to labour force survey data 33% of the labour force registered as unemployed in the third quarter of 2008, compared to 35% in 2007. At the same time, employment growth remained relatively strong, with 3.6% in the third quarter of 2008, compared to 3.5% in 2007 and 4.1% in 2006. However, a large part of those new jobs appear to be filled with newcomers who did not participate in the labour market before. As a result, unemployment remains high, in particular in the age group of 15-24, where the unemployment rate was at some 54% in the third quarter of 2008, compared to a similar level a year before. This age group accounts for some 20% of total unemployment.

Nominal wage growth accelerated to 8% in mid- 2008 and decelerated in the second half of 2008 to 6% in September. However, in real terms, wages declined, as nominal increases remained below consumer price inflation.

Prices

Consumer price inflation increased to nearly 10% in the beginning of 2008 but decelerated markedly during the year, reaching a 12-month increase of 4.1% in December. For the whole year of 2008, average inflation was 8.3%, compared to 2.3% in 2007. The main factors for this sharp increase where higher prices for food and energy.

Monetary policy

Monetary conditions remained relatively favourable during most of 2008. Average weighted nominal lending rates declined from 10.7% end of 2006, to 9.9% end of 2007 and to 9.6% in April 2008, but rose to 9.8% in November. Interest rates on deposits came down from 5.6% in December 2005 to 4.4% in December 2006, but rose again to 5.3% by December 2007 and to 6.5% in November 2008. Credit growth to the private sector was around 25% in 2006 and continued to accelerate to some 33% by end-2007. In the first ten months of 2008, the strong increase of credit continued, although the overall credit-to-GDP level is still relatively low. Year-on-year growth of M4 accelerated from 26% in the first quarter of 2007 to some 30% in the second and third quarter. However, in the fourth quarter, monetary expansion decelerated to some 20%.

The exchange rate of the Denar has remained largely unchanged against the euro on a level of 61.2 MKD/EUR. The National Bank intends to maintain the current informal peg vis-à-vis the Euro.

Foreign exchange reserves amounted to EUR 1.7 billion by November 2008. This corresponds to some 3 months of expected imports. However, as a result of a strong rise in expenditure for imports, the import coverage ratio is significantly lower than a year before.

By end September 2008, gross external debt amounted to 52% of GDP. After early debt repayments had led to a sharp drop in 2007, increased foreign borrowing by private enterprises had led to a rise in external debt.

Fiscal developments

The central government accounts registered a significant surplus of some 3% of GDP during the first ten months of 2008, mainly as a result of a better than expected revenue collection and lower than planned spending. However, preliminary data for the last months of 2008, point to a significant slowdown in tax revenues, and increased spending, leading to a central government deficit of nearly 1% of GDP. The main reason for the decline in tax revenues are is lower VAT revenue. Most likely, this shortfall reflects a decline in import due to lower energy prices, but also lower domestic activity as a result of declining global demand.

In December, parliament approved the government's budget proposal for 2009, envisaging a deficit of 2.8% of GDP, compared to a planned deficit of 1.5% in 2008. This fiscal target is based on an expected real GDP growth of 5½% in 2009 and inflation of 3½%.

The general government debt ratio declined from 42% of GDP at the end of 2006 to some 26% at the end 2007. This sharp decline is largely a result of early debt repayments, mainly to Paris club creditors, the IMF, the World Bank and the EIB.

Structural reforms

During 2007 and 2008 the authorities continued implementing structural reforms, primarily targeted towards improving the business climate.

To facilitate market entry, the authorities have simplified and shortened registration procedures. The newly established one-stop shop for business registration has been further strengthened, the duration of the registration procedure has been reduced to an average of 5 days and the costs of registration have lowered. With respect to market exit, bankruptcy procedures have been modernised, leading to a shortening of bankruptcy procedures.

The reform of the judiciary has started and real estate registration has been increased significantly. As a result, mid-2008 the degree of registration had reached some 78% of the country's territory. Banking supervision has been strengthened. Legislation on temporary employment has been modernised and steps have been taken to adjust the legislation on social contribution to the new labour code. Tax collection has been modernised which had positive effects on tax revenues.

Table III.III.4:
The former Yugoslav Republic of Macedonia - Main economic trends

		2002	2003	2004	2005	2006	2007	Q3 2008
Gross domestic product	Ann. % ch	0.8	2.9	4.1	4.1	4.0	5.9	5.5
Private consumption	Ann. % ch	12.5	-1.5	6.2	5.7	6.0	4.0f	:
Gross fixed capital formation	Ann. % ch	17.6	1.1	10.9	-5.4	11.6	20.0f	:
Unemployment	%	31.9	36.7	37.2	37.3	36.0	34.9	33.0
Employment	Ann. % ch	-6.3	-2.9	-4.1	4.3	4.6	3.5	3.6
Wages	Ann. % ch	6.9	4.8	4.0	2.7	8.0	4.8	6.1
Current account balance	% of GDP	-9.5	-4.1	-8.4	-2.6	-0.9	-3.0	-12.9
Direct investment (FDI, net)	% of GDP	2.1	2.4	6.0	1.6	6.8	4.3	8.2
CPI	Ann. % ch	2.3	1.1	-0.4	0.5	3.2	2.3	8.3*
Interest rate (3 months)	% p.a.	n.a.	n.a.	8.49	9.95	6.40	5.60	7.41
Bond yield	% p.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a
Stock markets	Index	n.a.	774	911	1,930	3,219	6,971	5,149*
Exchange rate MKD/EUR	Ann. avg	60.98	61.26	61.32	61.30	61.19	61.18	61.25*
Change real eff. exchange rate (CPI based)	% eop	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a
General government balance	% of GDP	-5.6	-1.1	0.0	0.2	-0.5	0.6	3.0
General government debt	% of GDP	48.6	44.9	43.8	48.5	41.5	29.0	:

* *Year 2008*

Sources: Reuters/Ecowin, national sources

III.5. MONTENEGRO

General macroeconomic situation

Economic growth has remained strong since the declaration of independence in mid-2006. Real GDP expanded by 10.7% in 2007 supported by a very successful tourist season and the rise in disposable income of households, boosted by rapid credit expansion and rising asset prices. The economy remained robust in 2008 growing by 8% in real terms until September, driven by services (notably tourism and financial intermediation). By contrast, industrial output was stagnant on the poor results of the manufacturing sector, and the metal industry in particular. On the demand side, cumulative retail sales remained solid in 2008, expanding by 17% in real terms during the first ten months.

International transactions

Negotiations on international trade issues advanced successfully. In July 2007 the Central European Free Trade Agreement (CEFTA) entered into force. In December, the European Parliament ratified the Stabilisation and Association Agreement, and the interim trade agreement entered into force on 1st January 2008. Negotiations on WTO accession are also well advanced, Montenegro signed in April 2008 a bilateral agreement with the EU, successfully concluding bilateral talks on this issue.

The strong demand-driven growth has also induced wide-scale macroeconomic imbalances. The trade deficit has been widening fast, closing to 50% of GDP by September 2008, as imports continued to increase, fuelled by the surge of investment and incomes. Meanwhile, exports recorded uneven results as visible goods outflows contracted while the services balance posted surpluses contributing to alleviate the trade deficit. As a result, the current account balance widened to 29% of GDP in 2007 and further deteriorated in annualised terms to 35% of GDP by end-September 2008.

On the capital account, FDI inflows have remained very strong. They represented 44.2% of GDP in 2007 after surging by 56% on the year. Yet, concurrent considerable outflows, mostly due to real estate sales by foreigners, brought net FDI to 22% of GDP. However the structure of investments changed in 2008 as inflows related to real estate property moderated markedly, while they continued to grow in favour of domestic enterprises and banks. During the first ten months of 2008 the capital account recorded robust net FDI of more than 17% of GDP, covering around 75% of the current account deficit.

External debt

Montenegro's private external debt is estimated at some 30% of GDP in 2007. Two years after the independence of the country, public debt has not yet been completely settled with all lenders. Though, the amounts in question are limited and should not substantially alter present debt levels. In 2007, stronger than expected fiscal performance allowed for early repayments of foreign loans, bringing public external debt down to 16.5% of GDP. The public external debt remained stable in 2008 at 16.6% of GDP by year's end.

Labour market

The strong growth also improved labour market dynamics. The labour force surveys conducted during 2007 and 2008 confirmed the improvement in participation, employment and unemployment rates. However, large regional disparities in employment subsist. The unemployment rate further decreased in 2008, recording 10.7% by year's end, while employment registered an annual growth above 6%.

Prices

Average annual inflation accelerated to 4.3% in 2007, notably due to a significant increase of food and energy prices, while year-end inflation increased to 7.7%, fuelled mostly by services (namely transport and telecommunications). Consumer prices continued accelerating during the first half of 2008, peaking in June at 11.4%, afterwards gradually decreasing as the base effect from the previous year faded away. Prices further decelerated in November to 6.5% year-on-year.

Industrial production prices also accelerated rapidly during the first half of 2008, recording its maximum expansion in June, led by the strong acceleration of prices in the metal industry since beginning of the year, but fell after July. Overall, industrial prices recorded a cumulated growth of 8.6% in the first eleven months of 2008.

Monetary and financial indicators

The country's use of the euro as sole legal tender provides a very restricted scope for using monetary policy instruments. Interest rates follow international markets (i.e. EURIBOR) plus a risk premium. The core monetary policy tool is reserve requirements and has been used to curb down the fast credit growth, notably consumption credits to households.

Total assets of banks in 2007 reached EUR 3 billion, boosted by the very rapid expansion of the credit portfolio to 98.6% of GDP. Until 2008, the share of deposits had been continuously higher than credits, providing for a high degree of liquidity. However, the lending activity kept accelerating faster during the year, surpassing deposits by end-2007. In January 2008 the Central Bank introduced a series of restrictive measures (notably, credit growth ceilings and increased minimum solvency coefficients), and to some extent succeeded in limiting the credit boom levels of the previous year. During the ten first months of 2008 total loans disbursed grew by 44% on the year, compared with 92% recorded by end-2007.

In October 2008, in the context of the global financial crisis, Montenegrin households withdrew a significant (12%) share of their bank deposits. The authorities reacted promptly by adopting a Law of support to the financial system guaranteeing bank deposits to the full amount, and also providing guarantees for interbank lending and the possibility of increasing liquidity of the lenders through loans and recapitalisation.

Meanwhile, the leasing market has benefited from the Central Bank's restrictive measures on commercial banks' credit, registering a rapid expansion of leasing activities in the first nine months of 2008 by more than 70% year-on-year. The sector accounts for some 6% of GDP.

Fiscal developments

The solid economic performance was also reflected in the surge of tax collection by 40% in 2007, resulting in a consolidated budget surplus of 6.4% of GDP by year end. The highest increases in fiscal revenues were recorded in corporate income tax (208%) and property tax (102% year-on-year). Yet the main contributor remained VAT, representing 31% of total current revenues. Consolidated expenditures grew more moderately by 16.7% over the year, representing 47% of GDP. The largest expenditure item (gross salaries) rose by 31%. The expenditure structure continued shifting: in particular capital spending increased by 66% over the year, to 7% of GDP.

Similar trends continued during 2008. Fiscal revenues remained growing as tax and contributions proceeds expanded by 28% year-on-year, fostered by growing tax revenues on international trade resulting from robust import growth. Yet, the highest expansion was recorded in corporate income tax, surging by 60%. Meanwhile, consolidated expenditures also increased significantly, reflecting the strong wage hike in the public administration at the beginning of the year, but also a significant increase in capital expenditures. Overall, in the first nine months of 2008 the consolidated budget recorded a surplus of 4.3% of GDP.

Public debt reached 26.3% of GDP in 2007, increasing by nominal 21.4% in the course of 2008 as domestic indebtedness surged by 50%. The main reason of this increase was the recognition of significant arrears from unpaid pensions. By contrast, the foreign public debt rose by modest 4.2%. The settlement of restitution claims remains an important challenges for the public finances.

Structural reforms

After some delays in 2007 the privatisation process resumed in 2008. Yet, revenues from privatisation remain modest. In the first half of 2008 they amounted to EUR 24.5 million.

After the completion of the banking sector's privatisation, financial reforms focused on the development of the institutional and regulatory framework. The government adopted in 2007 the Internal Operations Bill, regulating transfers and interbank clearance and providing the regulatory framework for the issuance of electronic payment instruments. It also adopted the Bill amending the Law on receivership and liquidation of Banks. In February 2008 the parliament adopted a new Law on Banks, representing a stricter approximation to Basel II standards. The most important novelty includes the introduction of a standardised approach in credit risk and operational risk, capital charge for market risk, and the setting of the capital requirements ratio at 10%. In October the parliament adopted the Law on Measures for the Protection of the Banking system, fully guaranteeing deposits, as well as inter-bank credits, and offering the possibility of providing liquidity loans or recapitalisation of domestic banks.

The insurance market, dominated by the car insurance segment, is rapidly developing with the entry of several new players in 2008. Meanwhile, the reform of the social security system advanced with the adoption in October 2007 of regulations on voluntary pension insurance, and the first voluntary pension fund obtained its operating license in March 2008.

The government adopted end-2007 an ambitious Energy Development Strategy to address the electric power deficit and high imports. In March 2008, prior to the opening of the electricity market, the incumbent power utility EPCG launched its restructuring into separate business units.

Table III.III.5:
Montenegro - Main economic trends

		2002	2003	2004	2005	2006	2007	Q3 2008
Gross domestic product	Ann. % ch	1.9	2.5	4.4	4.2	8.6	10.7	8.0
Private consumption	Ann. % ch	6.4	:	:	:	:	:	:
Gross fixed capital formation	Ann. % ch	-16.1	:	:	:	:	:	:
Unemployment	%	28.9	26.0	22.3	18.5	14.7	11.9	10.7*
Employment	Ann. % ch	-0.3	-3.3	:	2.0	3.8	5.6	6.0
Wages	Ann. % ch	n.a.	n.a.	11.7	8.0	15.6	14.2	25.0
Current account balance	% of GDP	-12.0	-6.8	-7.2	-8.5	-24.7	-29.4	-35.4
Direct investment (FDI, net)	% of GDP	6.6	2.6	3.0	21.0	21.7	18.7	17.3
CPI	Ann. % ch	16.4	6.8	2.2	2.4	3.0	4.3	9.2
Interest rate (3 months)	% p.a.	n.a.	n.a.	10.58	1.20	1.21	:	:
Bond yield	% p.a.	n.a.	n.a.	9.98	3.09	1.17	0.90	:
Stock markets	Index	n.a.	1,000	1,758	5,670	14,406	36,159	19,947*
Exchange rate EUR/EUR	Ann. avg	1.00	1.00	1.00	1.00	1.00	1.00	1.00*
Change real eff. exchange rate (CPI based)	% eop	n.a.	0.0	1.9	2.4	3.1	5.1	10.3
General government balance	% of GDP	-1.9	-2.4	-2.6	-2.3	2.7	6.4	4.3
General government debt	% of GDP	84.5	47.1	44.5	38.6	32.6	26.3	30.9*

* *Year 2008*

Sources: Reuters/Ecowin, national sources

III.6. SERBIA

General macroeconomic situation

The Serbian economy is increasingly being affected by the continuing global economic and financial crisis. While Serbian banks are not directly affected by the decline in asset values of mortgages related structural products, the adverse effects of the financial crisis on global asset and credit markets are increasingly affecting Serbia. Refinancing lines from foreign parent banks have become more expensive as mother banks are passing on their increased cost of financing to Serbian subsidiaries. The availability of cross-border borrowing from foreign banks directly to the domestic corporate sector has declined and trade financing has become more difficult. The maturity of foreign loans has been shortened with the maximum duration now being up to one year. Domestic interest rates have been increased and several banks have tightened their lending standards.

As a result, GDP growth slowed to 4.9% year-on-year during the third quarter of 2008, compared to 6.3% year-on-year during the second quarter. During the first nine months of 2008, GDP grew by 6.5% year-on-year. Growth of industrial production slowed to 1.0% year-on-year during the third quarter of 2008 compared to 2.3% during the second quarter on weaker domestic and global demand. The declining trend continued during the fourth quarter with industrial output falling by 3.4% year-on-year and 2.6% year-on-year in October and November, respectively. In response to the decline in world demand for steel, US Steel, one of Serbia's leading exporters, closed one plant in Serbia. However, the agricultural and food processing sectors held up well due to the good 2008 harvest.

International transactions

During the third quarter of 2008, exports and imports of goods grew by 29.8% and 33.6% year-on-year, respectively contributing to a further widening of the current account deficit to 17.0% of GDP, compared to 16% a year earlier. However, high frequency indicators show that imports have started to decelerated much faster than exports during the forth quarter of 2008 due to the slowdown of domestic demand. This suggests that a significant adjustment of the current account may already be under way.

During the third quarter of 2008, the financial account recorded net inflows in the order of 18.9% of GDP, more than offsetting the current account deficit. FDI and portfolio investment declined to 1.5% and 0.3% of GDP, respectively. Credit to the corporate sector recorded a net outflow of -1.9% of GDP while net inflows of credit to financial institutions increased to 15.1% of GDP. Servicing of foreign debt increased to 8.0% of GDP.

At end-2008, the stock of foreign exchange reserves of the NBS stood at EUR 8.1 billion, compared to EUR 9.6 billion a year earlier, as the NBS has repeatedly sold euro to provide foreign currency liquidity to the interbank foreign exchange market during the course of the year.

External debt

As a result of the growing debt financing of the external deficit, foreign debt rose to EUR 21.7 billion at end-November 2008, accounting for a projected 67% of GDP, compared to EUR 18.9 billion or 61% of GDP at end-2007. Private and public sector foreign debt accounted for 47% and 20% of GDP, respectively. Debt servicing is projected to increase to 9.7% of GDP in 2008 and to continue rising in the coming years.

Labour market

Labour market conditions have improved in 2007 and 2008, when employment rose by 1% and 0.2% year-on-year, respectively, following several years of decline. Unemployed also declined to a rate of 12.5%, compared to 18.8% a year earlier. Nominal gross wages grew by 17.9% year-on-year on average in 2008, compared to 18.8% a year earlier. As the cost of living slowed even faster, real wage growth pick-up to 5.3% year-on-year during the third quarter of 2008.

Prices

Retail price inflation accelerated to an annual average of 10.7% in 2008, compared to 6.8% a year earlier. Inflation has peaked in mid-2008 (at 12.3%) and slowed thereafter. The decline in the price of petroleum and its derivatives in world markets as well as a better harvest contributed to the decline in inflation during the second half of the year. However, the depreciation of the local currency since October has reduced this disinflationary effect somewhat and retail price inflation stood at 6.8% year-on-year in December.

Monetary policy

The new monetary policy framework, introduced in September 2006, aims at a gradual transition towards inflation targeting with explicit objectives for core inflation. The latter stood at 10.1% year-on-year end-2008, significantly exceeding the upper bound of the target range of 3-6% for the whole year of 2008, due to high inflation expectations.

To stem rising inflationary pressures but also to help support the local currency, which had repeatedly come under depreciation pressure in the foreign exchange market during the course of 2008, the NBS increased its repo rate by a total of 775 basis points to 17.75% by year-end. The dinar lost about 11% vis-à-vis the euro during the whole year. The NBS repeatedly intervened in the interbank foreign exchange market to smooth the fluctuations of the dinar and to increase foreign exchange liquidity in the local interbank market. In this context, foreign exchange reserves at the NBS declined by some EUR 1.5 billion during 2008 to EUR 8.1 billion at year-end. In addition, to help stem the accelerated depreciation during the fourth quarter 2008, the NBS increased the amount of guaranteed deposits, lifted reserve requirement for banks' foreign borrowing and eliminated the tax on savings income to help boost foreign exchange liquidity of the local market.

Fiscal developments

For 2008, a revised budget, which was adopted by the government in early October, foresaw a deficit of the consolidated government budget to increase to 2.7% of GDP, compared to an initially planned deficit of 1.7% of GDP. The is due to an extraordinary 10% pension increase - which entered into force in October - and other additional spending plans, which boosted expenditure to 45.4% of GDP, adding additional demand pressures on an economy hampered by growing macroeconomic imbalances.

The execution of the consolidated general government budget for 2008 may have resulted in a deficit of 2.2% of GDP, significantly below target. However, due to the ongoing slowing of economic activity, a downward revision of the underlying GDP assumption may result in a higher deficit for 2008. Revenue collection and total expenditures were almost on target compared to the annual projections. However, higher expenditures on social-assistance and subsidies were compensated by savings in the execution of the public investment plan.

Following the agreement with the IMF, the parliament adopted the 2009 budget in December. In early January, national authorities indicated that there might be a need for revisions of the budget in the first quarter of 2009 due to the deterioration of the global economic environment and the related decline in revenues. The main objectives of the 2009 draft budget are (i) to reduce the general government deficit to 1.5% of GDP; (ii) to reduce current spending by -1.5% of GDP, in particular by cutting subsidies, limiting public sector wage increases to projected inflation, and freezing pensions for 12 months; (iii) to increase capital spending by 0.3% of GDP; and (iv) to increase revenues by 0.6% of GDP through higher excise taxes on diesel and gasoline as well as a transfer of 50% of net profits of public enterprises to the budget. The deficit is foreseen to be financed through privatisation proceeds of 1.7% of GDP and external borrowing from IFIs in the order of 0.7% of GDP. An increase of the VAT rate is considered a last resort measure to achieve the deficit target.

Structural reforms

Privatisation of socially-owned companies continued in late 2007 and 2008, both in the form of tenders and auctions. About 400 socially-owned companies were sold in 2007 (16 tenders, 283 auctions, and over 100 companies sold through the sale of state-owned stakes in the capital market). This was followed by about 40 privatisations in the first two months of 2008, but the process slowed in March. The total number of privatised companies since the process started in 2002 has risen to over 2,200 by end-2008. The number of firms that still need to be sold has consequently declined to about 700. A commission for the privatisation of public utilities has been set up and the government plans to privatise two state-owned companies by year end.

Four large state-owned companies (electric company EPS, Telekom, Belgrade Airport, and pharmaceutical company Galenika) are planned to be offered for sale through initial public offerings. The selection of privatisation advisors has started and it is expected that the first few companies will be sold in 2009 and the whole process completed by 2010. A tender for sale of national flag carrier JAT Airways failed due to lack of interest. The oil conglomerate NIS has been sold as part of a framework agreement for supply of gas and oil with Russia. Serbia has entered with Fiat of Italy into a joint venture to revive local ailing car manufacturer Zastava. The question of privatisation of about 500 utilities at the level of local communities also remains open – their restructuring and reorganisation have not begun yet, while the concept of their privatisation remains undefined.

Table III.III.6:
Serbia - Main economic trends

		2002	2003	2004	2005	2006	2007	Q3 2008
Gross domestic product	Ann. % ch	4.2	2.5	8.2	6.0	5.6	7.1	4.9
Private consumption	Ann. % ch	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a
Gross fixed capital formation	Ann. % ch	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a
Unemployment	%	13.3	16.0	19.5	21.8	21.6	18.8	12.5
Employment	Ann. % ch	-3.5	-2.7	0.4	-6.7	-3.8	1.0	0.2
Wages	Ann. % ch	30.5	25.3	23.7	24.1	24.4	22.1	17.9
Current account balance	% of GDP	-7.9	-7.5	-13.4	-8.3	-9.4	-14.9	:
Direct investment (FDI, net)	% of GDP	3.0	6.1	3.9	5.9	13.5	5.9	:
RPI	Ann. % ch	19.5	11.7	9.8	17.3	12.7	6.8	10.7*
Interest rate (3 months)	% p.a.	n.a.	n.a.	21.16	17.54	13.48	6.44	:
Bond yield	% p.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a
Stock markets	Index	n.a.	n.a.	n.a.	1,954	2,658	3,831	2,604*
Exchange rate CSD/EUR	Ann. avg	60.75	65.29	73.10	83.25	83.91	79.90	81.94*
Change real eff. exchange rate (CPI based)	% eop	16.8	0.0	-0.5	0.2	9.6	23.0	3.6
General government balance	% of GDP	-3.1	-1.1	0.9	0.9	-1.6	-2.0	-0.3
General government debt	% of GDP	80.6	64.3	53.3	50.3	36.2	29.4	25.2

* Year 2008

Sources: Reuters/Ecowin, national sources

III.7. KOSOVO (UNSCR 1244)

General macroeconomic situation

The Statistical Office of Kosovo revised GDP figures upwards for the years 2004-2006, leading to some changes in the interpretation of Kosovo's macroeconomic performance. Especially, the formerly estimated recession in 2005 turned into a close to 4% growth rate. However, the general picture that Kosovo lags behind its neighbours and that growth is too sluggish in order to meet the substantial development needs remains unchanged, even though annual growth rates are now closer to those observed elsewhere in the region with 4% in 2006 and 4.1% in 2007. In 2008, growth is expected to have been above 5%. However, GDP per capita – some € 1,800 in 2008 - is still one of the lowest in Europe.

On 17 February 2008, Kosovo declared its independence and was subsequently recognised by 22 EU Member States, the US, Japan and a number of other non-EU countries. On 15 June 2008, the new Kosovo Constitution came into force. In July 2008, Kosovo applied for membership in the IMF and the World Bank.

International transactions

Despite a sharp increase of exports of 32% in 2007 compared to the previous year (after even doubling in 2006), followed by a 56% increase in exports during the first months of 2008, the trade deficit (goods only) widened to 42.6% of GDP in 2007 and has continued to widen throughout 2008 due to the small export base. Imports grew by 21% in 2007 after 13% in 2006, and continued to grow by 22% during the first nine months of 2008. The 12-month average of the coverage ratio (exports in percent of imports) improved from 8.4% in 2006 to 10.6% in 2007 and 11.2% in September 2008. Due to the weak export base, the external situation of Kosovo remains precarious.

The current account deficit (including foreign assistance) increased from 13.8% of GDP in 2006 to 17.4% in 2007. It was mainly financed by foreign direct investments which rose on the back of accelerated privatisation activity in 2007 to 12.6% of GDP after 8% in 2006 and only 2.8% in 2005. Workers' remittances increased to 12.9% of GDP from 11.6% in 2006. The level of foreign assistance decreased from 10.3% of GDP in 2006 to 8.9% in 2007. In 2008 remittances have remained strong and continued to be an important source of income for Kosovo households.

External debt

Kosovo currently does not assume any sovereign debt servicing obligations. However, Kosovo is expected to take over a share of external debt from Serbia after a possible arbitration process, and has started by earmarking funds for notional debt servicing in its medium-term budget planning. Current preliminary estimates for the amount of public debt possibly to be transferred to Kosovo range around 25% of GDP, mainly to the World Bank, Paris Club and London Club creditors.

Labour market

The number of registered job seekers continued to increase in 2007 to 332,000 persons as a yearly average, up by 8,500 compared to 2006, and further to 336,000 in the first half of 2008. Long-term unemployment remains particularly high, pointing to limited dynamics and flexibility of the Kosovan economy and labour market. However, the estimated unemployment rate of around 43% should be interpreted with caution in view of the sizable informal sector.

Prices

After years of low – in 2004 and 2005 even negative – inflation, price increases accelerated in the second half of 2007. Year-on-year rates remained at double-digit figures between October 2007 and July 2008, reaching 10-14%, before base effects were kicking in. Since August 2008, rates have come down to previous levels with the December 2008 figure at 0.5%. Average annual inflation reached 9.4% in 2008, after 4.4% in 2007 and 0.6% in 2006. This episode of high inflation was mainly driven by food prices which increased by around 25% year-on-year in late 2007 and the first half 2008, while this group of consumption items accounts for almost half of the consumer basket. Due to a general lack of economic data it is difficult to judge the effect on real demand. Judging from fiscal revenue data, some consumption may have been diverted to local production for own use. The Statistical Office of Kosovo has just finished compiling revised national accounts for 2004-2006, therefore a more precise analysis of the high inflation period has to wait for national accounts data becoming available for 2007 and 2008.

Monetary policy

Kosovo continues to rely on the euro as the currency in use. The Central Bank of Kosovo (CBK), therefore, cannot implement any independent monetary or exchange rate policy. Its role lies in supervising the financial sector, monitoring liquidity in the banking sector and credit expansion, with liquidity ratios and reserve requirements as main policy tools.

Despite conservative prudential requirements, annual credit growth substantially accelerated in 2007: comparing year-end data, the total volume of loans increased by 40% in 2007. The interest rate spread between deposits and loans is very high and only showed a very slow downward trend (decreasing to 11.3 percentage points in 2007 from 11.8 in the previous year). Nevertheless, financial intermediation deepened further.

The banking sector in Kosovo remained relatively sound and profitable. The capital adequacy ratio of commercial banks increased from 16.7% in 2006 to 17.5% in 2007, before falling again to 16.5% in 2008. The return on average equity reached another record high of 28.7% in 2007, up from 23.1% in 2006, but decreased considerably in 2008 to 20.2%, the return on average assets climbed to 2.6% in 2007 from 1.8% in 2006, before decreasing slightly to 2.3% in 2008. The ratio on non-performing loans remaind very low in 2008 at a level of 3.3%.

Fiscal developments

Budgetary developments in Kosovo have been quite volatile and hard to predict in recent years. The primary balance turned from a deficit of 3.1% of GDP in 2005 to surpluses of 2.5% in 2006 and even 7.2% in 2007. 2008 is expected to post a deficit of around 1.3% of GDP after both current and capital spending was increased substantially. The government has adopted a 2009 budget on the assumption of unchanged buoyant growth of tax revenues and further strong increases in capital budget execution rates resulting in a primary deficit of 3.3% of GDP. On the one hand, the outlook on revenue growth may turn out to be overly optimistic (see the analysis on real revenues in section 1.2), on the other hand the assumed capital budget execution may be too optimistic as well. Subsidies to the ailing electricity utility KEK have been substantially increased, but are foreseen in the budget planning to be neutral as the government expects the subsidies of 2008 and 2009 to be paid back in the course of the privatisation expected by end- 2009. Given the state of preparation for this privatisation, international observers agree that such an assumption is highly unrealistic undermines the reliability of budget planning. The actual planned deficit may therefore be seen rather in the region of 10% of GDP.

In both 2006 and 2007, the fiscal stance had remained more restrictive than initially planned, due to higher than expected revenue collection and a continuously weak spending record, especially on capital items. The cash balance of the government rose from around € 200 million at the end of 2006 to almost € 440 million (13% of GDP) one year later and was expected to remain roughly stable in 2008.

The 2008 budget as well as the planned 2009 budget are strongly expansionary in nature and divert significantly from the fiscal rule which was agreed with the IMF in 2005 according to which real current primary expenditure should rise by no more than 0.5% year-on-year. Instead, it is set to rise by approximately 12.5% in 2008 and by at least another 4% in 2009. Capital expenditures in 2008 almost doubled compared to the 2007 outcome, and the adopted 2009 budget foresees a further increase by 50% over the executed level of 2008. Capital spending continues to suffer from the lack of project planning and implementation capacity in the line ministries and exhibits low spending efficiency. However, even more problematic are the hikes in public wages and current spending on goods and services (which in Kosovo to a large extent contains non-pecuniary wage items). Primary current spending increased by 21% in 2008 and public wages and salaries are budgeted to increase by another 17.4% in 2009.

In May 2008, the Government of Kosovo had presented an enhanced Medium-Term Expenditure Framework 2008-2011 (MTEF) in which it defined a set of policy priorities including economic growth and good governance. This MTEF served as guidance to the international donors' conference held in Brussels on 11 July 2008 which resulted in pledges of €1.2 billion for the socio-economic development of Kosovo, addressing financing needs identified in the MTEF. The budgetary developments in 2008 and 2009 however represent substantial deviations from this MTEF. Due to these deviations, ongoing talks with the IMF on a Letter of Intent could not be concluded. An understanding on a set of viable economic and financial policies is a pre-condition for budget support which has been granted by the European Community in 2006, and also considered a prerequisite by the World Bank for the release of donors' trust funds that it manages.

Structural reforms

In 2007, the privatisation process continued with ten rounds of tenders launched by the Kosovo Trust Agency (KTA). In total, the privatisation proceeds from signed and pending contracts amount to around €370 million. However, the process came to a standstill after a ruling of the Special Chamber of the Kosovo Constitutional Court put into question the method of privatisation and its compatibility with the principles on private property of the European Convention on Human Rights. These concerns have been addressed in 2008 in the law on the KTA successor, the Privatisation Agency of Kosovo (PAK) which yet has to become fully operational. In the meantime, the PAK became operational, but the privatisation process has by no means returned to the level of activity seen in 2007. As a consequence, only small amounts of FDI are expected to have been triggered by this process in 2008.

The restructuring of publicly-owned enterprises remains one of the biggest challenges of structural policy. Infrastructure remained insufficient and often of poor quality. In particular, the situation in the energy sector is critical – the power supply infrastructure remained unreliable, with frequent power cuts, affecting economic activity at large. Furthermore, the efficiency of the judiciary system and law implementation remained low and only little progress was made in enforcement of contracts and court rulings as well as on the establishment of property rights.

Table III.III.7:
Kosovo (UNSCR 1244) - Main economic trends

		2002	2003	2004	2005	2006	2007	Q3 2008
Gross domestic product	Ann. % ch	-2.4	-0.1	3.4	3.9	4.0	4.1	:
Private consumption	Ann. % ch	2.0	1.9	3.6	8.0	4.2	7.6	:
Investment	% of GDP	-12.8	-7.4	-3.1	4.7	10.3	12.4	:
Unemployment	%	47.0	49.7	39.7	41.4	44.9	43.0	:
Employment	Ann. % ch	9.7	-24.8	61.2	-1.0	-10.2	10.8	:
Wages	Ann. % ch	N.A.	2.0	9.3	8.5	7.8	:	:
Current account balance	% of GDP	-8.0	-8.4	-13.0	-13.0	-13.6	-17.0	:
Direct investment (FDI, net)	% of GDP	0.4	0.7	0.7	2.7	7.7	9.2	:
CPI	Ann. % ch	3.6	1.2	-1.1	-1.4	0.6	4.4	9.8
Interest rate (3 months)	% p.a.	15.60	14.63	15.69	15.60	15.47	15.49	:
Bond yield	% p.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a
Stock markets	Index	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a
Exchange rate EUR/EUR	Ann. avg	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Change real eff. exchange rate (CPI based)	% eop	-1.5	0.5	-3.0	-7.9	-10.4	-0.1	:
General government balance	% of GDP	4.4	2.1	-4.5	-3.0	2.4	7.1	:
General government debt	% of GDP	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a

Sources: IMF, national sources

ANNEX
Abbreviations

AC	Acceding Countries
ALL	Albanian Lek
ATMs	Autonomous trade measures
BEEPS	Business Environment and Enterprise Performance Survey
BiH	Bosnia and Herzegovina
CAD	Current account deficit
CARDS	Community Assistance for Reconstruction, Development and Stabilisation
CAS	Country Assistance Strategy
CBBH	Central Bank of Bosnia and Herzegovina
CBK	Central Bank of Kosovo
OECD	Organisation for Economic Co-operation and Development
CEEC	Central and Eastern European Countries
CEFTA	Central European Free Trade Agreement
CEM	Country Economic Memorandum
CPI	Consumer Price Index
DIN	Serbian Dinar
EBRD	European Bank for Reconstruction and Development
EC	European Community
ECA	Europe and Central Asia
ECHO	European Community Humanitarian Office
EFPs	Economic and Fiscal Programmes
EIB	European Investment Bank
EU	European Union
EUR	Euro
FBiH	Federation of Bosnia and Herzegovina
FDI	Foreign Direct Investment
FIAS	Foreign Investment Advisory Service
FIPA	Foreign Investment Promotion Agency
FTA	Free Trade Agreement
fYRoM	The former Yugoslav Republic of Macedonia
GDP	Gross domestic product
GFCF	Gross fixed capital formation
GFS	Government Finance Statistics
GNP	Gross national product
HRK	Croatian Kuna
ICT	Information and communication technology
IDA	International Development Association
IFC	International Finance Corporation
IFIs	International Financial Institutions

ILO	International Labour Organization
IMF	International Monetary Fund
IPA	Pre-Accession Instrument
ISG	Infrastructure Steering Group
KFOR	Kosovo Peacekeeping Force
KM	Convertible Mark
KTA	Kosovo Trust Agency
LFS	Labour force survey
M&E	Machinery and equipment
MFA	Macro-financial assistance
MFN	Most-favoured nation
MKD	Macedonian Denar
MoU	Memorandum of Understanding
MTEF	Medium-Term Expenditure Framework
NACE	Statistical Classification of Economic Activities in the European Community
NATO	North Atlantic Treaty Organization
NIS	Newly Independent States
NMS-10	New Member States from Central and Eastern Europe (i.e. without Cyprus and Malta)
OHR	Office of the High Representative (BiH)
OJ	Official Journal of the European Union
OSCE	Organization for Security and Co-operation in Europe
PAK	Privatisation Agency of Kosovo
PEPs	Pre-Accession Economic Programmes
PIP	Public Investment Program
PPP	Purchasing power parity
PPPs	Public Private Partnerships
PRGF	Poverty Reduction and Growth Facility
PRSP	Poverty Reduction Strategy Paper
RS	Republika Srpska
SAA	Stabilisation and Association Agreement
SAp	Stabilisation and Association Process
SBA	Stand-by Arrangement
SDR	Special Drawing Right
SEE	South-East Europe
SMEs	Small and Medium sized Enterprises
SMP	Staff Monitored Programme
SOEs	Socially owned enterprises
STM	SAp Tracking Mechanism
T-bill	Treasury bill

TFP	Total Factor Productivity
TSA	Treasury Single Account
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNMIK	UN Interim Administration Mission in Kosovo
UNSCR	United Nations Security Council Resolution
USD	United States Dollar
VAT	Value Added Tax
WB	World Bank
WBs	Western Balkans
WTO	World Trade Organization
Yoy/y-o-y	Year-on-year