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Policies and Prospects

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- Liquidity and solvency problems
- Macroeconomic stability: labour costs
- Fiscal devaluation: expenditure cuts and tax hikes
- Interest rates and euro crisis
- Country by country prospects

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Liquidity and Solvency

- There are significant and rising liquidity problems throughout the region – payments delayed by many months, delays in credit repayments and budget arrears
- Most of that is in fact insolvency especially in construction but also in industry and as a consequence in the banking sector (continuous increase of non-performing loans)
- Institutional and policy frameworks are not well suited to dealing with solvency problems in particular
- The key problem is high foreign debt, mostly in the private sector and increasingly in the public sector too

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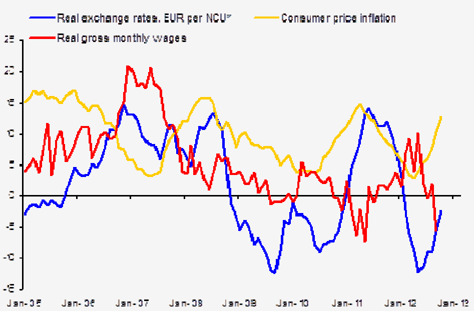
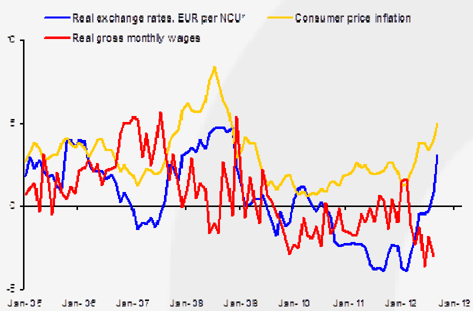
Macroeconomic Stability I

Serbia: Exchange rates, consumer prices and wages 2005-2012
year-on-year growth in %



Croatia: Exchange rates, consumer prices and wages 2005-2012
year-on-year growth in %



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Serbia and Croatia: Policy Framework

- Macroeconomic stability in **Serbia** is precarious due to the lack of an anchor for economic policy – there is a wage cost push, inflationary correction of real wages, and managed exchange rate to keep inflation in check
- So, intermittently, there are wage freezes, bursts of inflation, and stabilization of the exchange rate – with low employment, high average inflation rate, and growing foreign debt
- In **Croatia**, the exchange rate is the (only) anchor of stability – it supports growing foreign debt, which is the main constraint on growth; nominal wage adjustment and labour shedding are main adjustment mechanisms
- Social stability may prove a problem in both countries

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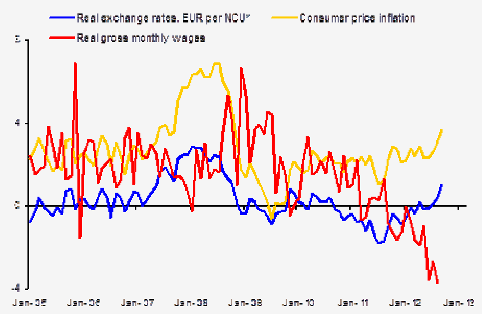
Macroeconomic Stability II

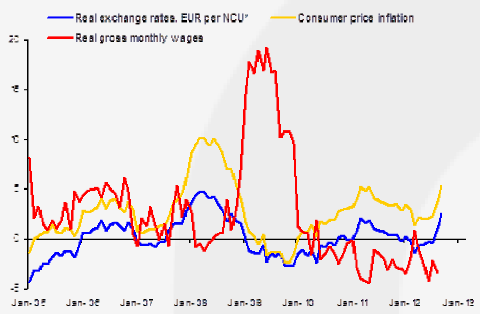
Slovenia: Exchange rates, consumer prices and wages 2005-2012

year-on-year growth in %



Macedonia: Exchange rates, consumer prices and wages 2005-2012

year-on-year growth in %



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Slovenia and Macedonia: Policy Framework

- Real exchange rate is anchored by euro adoption or strict peg to euro with inflation and wages being for the most part well behaved
- Stability is threatened by the need to adjust through lower real wages that cannot be achieved by either devaluation or inflation but through wage and tax cuts
- Social stability more threatened in **Slovenia** than in **Macedonia** due to different sensitivities to labour market developments

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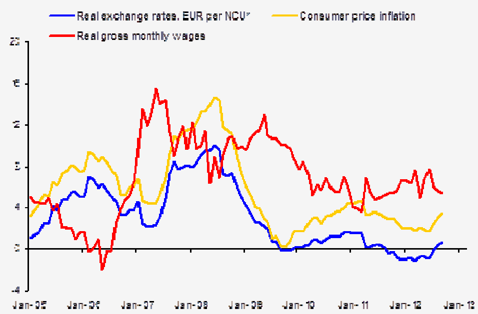
Macroeconomic Stability III

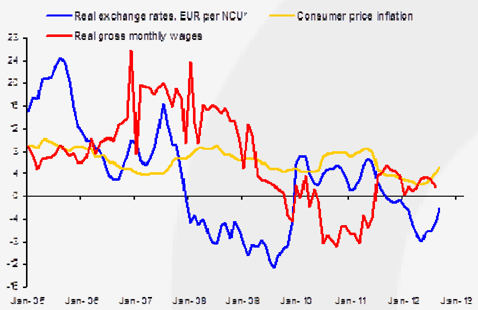
Bulgaria: Exchange rates, consumer prices and wages 2005-2012

year-on-year growth in %



Romania: Exchange rates, consumer prices and wages 2005-2012

year-on-year growth in %



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Bulgaria and Romania: Policy Framework

- **Bulgarian** currency board does not guarantee low inflation and thus real exchange rate stability
- In the past incomes policy, sluggish wage growth, was the anchor, but that may have changed just before the crisis and ever since; still wages are low by comparison with other countries in the region, so that may still not be a problem
- **Romania** seems to have stabilized the rate of inflation, though at a relatively high level

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Other countries: Policy Framework

- **Montenegro** uses euro and has pursued countercyclical fiscal policy
- **Bosnia and Herzegovina** has a currency board and significant private and public transfers from abroad
- **Albania** targets inflation and relies on remittances and financing by the multilaterals
- **Kosovo** uses euro and financial transfers too
- Social stability in these countries is less of a problem for variety of reasons

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Competitiveness

- Most of the countries rely on **fixed exchange rates**
- Those that do not – **Serbia, Romania, Albania – manage their exchange rates**, so the adjustment to competitive pressures do not differ all that much
- Mainly, competitiveness erodes due to wage growth, while it improves through decline in employment

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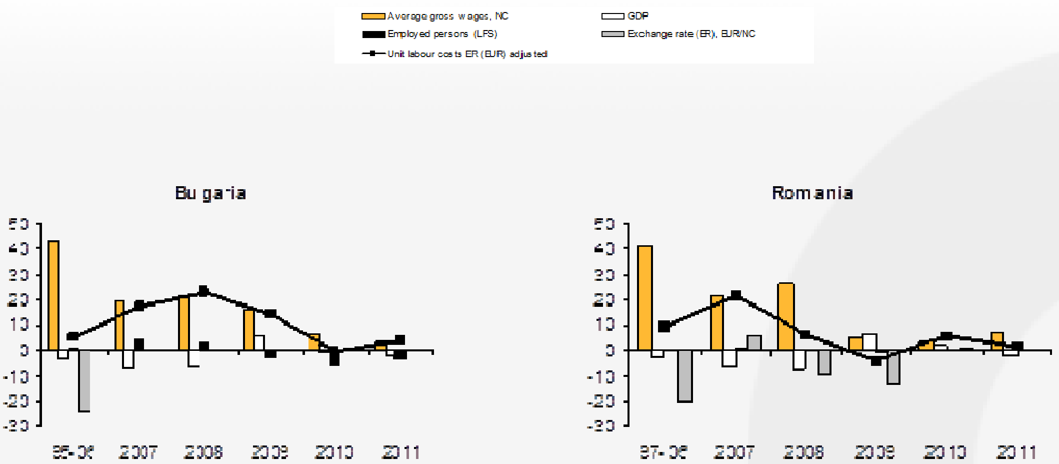
Unit labour costs, contribution of components



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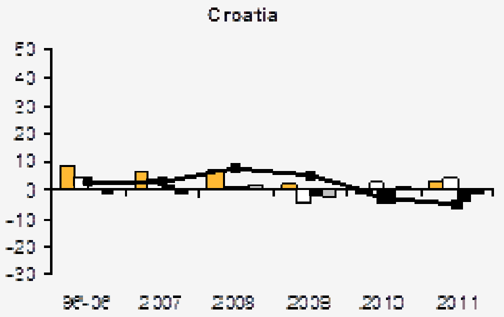
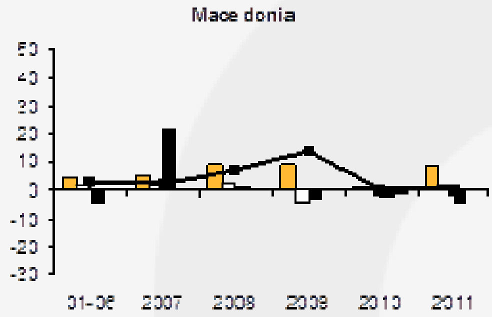
Unit labour costs, components





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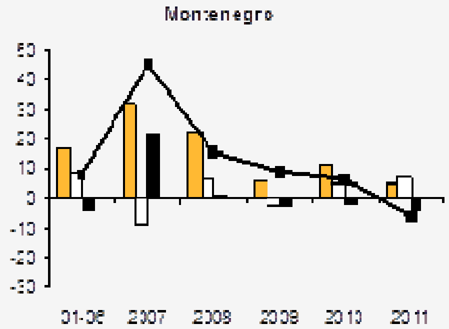
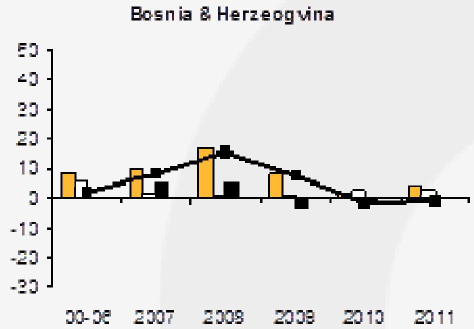
Unit labour costs, components





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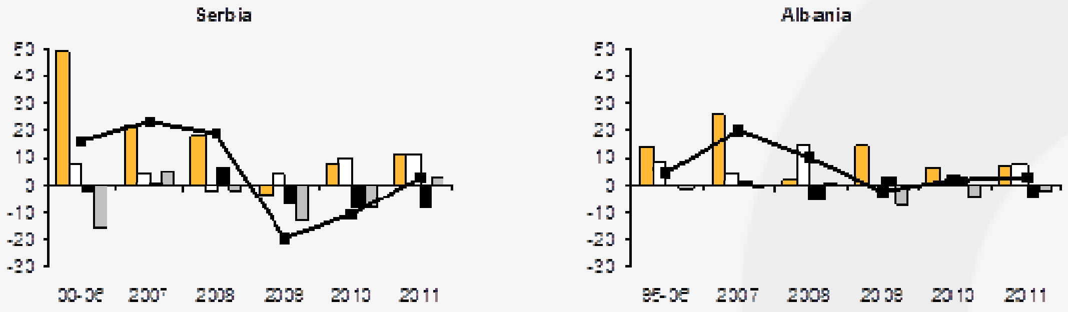
Unit labour costs, components



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Fiscal Devaluation

- Initially, a mix of slowdown of growth of expenditure and some tax adjustments (an increase of VAT in Croatia)
- Ahead, various types of fiscal devaluations
- As a rule, expenditures will tend to decline, while revenues are set to increase – with the aim of fiscal responsibility
- Thus, as a rule, domestic demand will remain depressed, certainly in the short run

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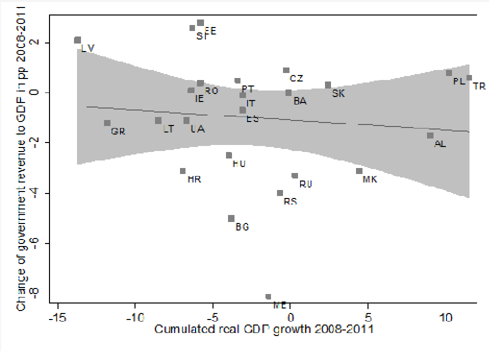
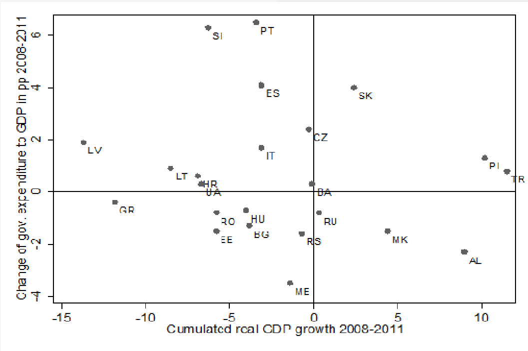
Fiscal Adjustment

Change of general government revenues and GDP growth 2008-2011



Change of general government expenditures and GDP growth 2008-2011



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Interest rates

- The costs of borrowing have declined lately, mostly as a consequence of the lower risk of euro dissolution
- Still, real interest rates (or interest rates in euro) are by about 2 to 3 percentage points above "the natural rate", partly due to rising non-performing loans (above 20 percent for corporate debt in Croatia and Serbia)
- However, demand for credit is low, due to the ongoing process of corporate balance-sheet consolidation and the deleveraging of households
- Banks are also deleveraging, partly because of improved liquidity due to the growth of savings
- The influence of monetary policy is limited even where exchange rates are not fixed

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Country Overview: Serbia

Main constraint: foreign debt (just over 100% of GDP), almost evenly split between private and public debts

Main policy issue: pro-cyclical fiscal policy with high public expenditures and taxes and growing public debt coupled with reliance on inflation

Main problem: low employment (below 50 percent)

Structural issues: corporate sector insolvency (public, but also private), weak institutional framework, low investment, low level of exports

Main advantage: possibility to rely on the flexible exchange rate

Prospects: Sluggish recovery in the medium run

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Country Overview: Croatia

- Main constraint: foreign debt, both private and public
- Main policy issue: fiscal devaluation
- Main problem: low employment
- Structural issues: Corporate sector insolvency (e.g. construction), declining investment, indexation due to the dominance of the exchange rate policy, inefficient institutional framework
- Main advantage: EU member from mid-2013
- Prospects: Risks are for several more quarters of recession and slow recovery afterwards

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Country Overview: Macedonia

- Main constraint: Investment
- Main policy issue: depressed domestic demand
- Main problem: high unemployment
- Structural issues: weak institutional framework, rigid corporate sector, segmented labour market
- Main advantage: competitive wages
- Prospects: due to high dependence on regional development and policy framework that depends on external demand, speed up of growth is unlikely as long as the neighbouring markets remain depressed

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Country Overview: Bosnia and Herzegovina

- Main constraint: institutional set up
- Main policy issue: fiscal policy
- Main problem: low employment
- Structural issues: internal market integration, infrastructure development
- Main advantage: scope for growth of industry
- Prospects: Due to regional dependence, slow growth for some time

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Country Overview: Montenegro

- Main constraint: external imbalances
- Main policy issue: weaknesses in the financial sector
- Main problem: growing unemployment
- Structural issues: institutional weaknesses, regional differences, infrastructure development
- Main advantage: tourism
- Prospects: Slow recovery due to weak external demand

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Country Overview: Albania

- Main constraint: external imbalances
- Main policy issue: low supply
- Main problem: declining remittances
- Structural issues: low domestic savings and investments, weak public sector, weak institutions, demographic pressure
- Main advantage: tourism (still quite underdeveloped)
- Prospects: slowdown of growth and slow growth

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Country Overview: Kosovo

- Main constraint: external imbalances
- Main policy issue: trade policy and public investments
- Main problem: very low employment
- Structural issues: institutional weaknesses, reliance on remittances, low investments
- Main advantage: abundant labour supply
- Prospects: given high regional dependence and possible international disengagement, relatively low growth rates if strong development policies are not implemented

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Country Overview: Bulgaria

- Main constraint: foreign debt
- Main policy issue: state of corporate debt
- Main problem: rising unemployment
- Structural issues: institutional weaknesses, low domestic investments
- Main advantage: low wages
- Prospects: Given the dependence on external demand, slow recovery as long as recovery is sluggish in the euro zone

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Conclusions

- Persistent solvency and liquidity problems
- Restrictive policy framework
- Dependence on external demand
- Depressed labour market
- Uncertain recovery of investment
- Slow recovery in the short and medium run
- Growth significantly below potential absent major external and policy improvements