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SEE countries: the main challenges on the road to recovery and the role of international financial institutions[2]

The post-crisis economic recovery in Southeastern European countries (SEE[3]) is fairly diverse. Some countries have been more successful in stimulating growth, while others have been still struggling with negative growth or sluggish recovery. The most recent IMF projections point that in 2014, for the first time since the onset of the crisis, all SEE countries will experience positive growth rates, bringing the activity in their economies above the pre-crisis level. With monetary and fiscal policy buffers being almost depleted, and with small probability the pre-crisis growth model driven by large capital inflows to continue, the focus has been put on enhancing structural reforms and devising new growth model. Structural reforms should be conducive to alternative growth model, which relies on higher exports, diversification of the structure of exports and export markets, attraction of FDI as the most stable and beneficial type of foreign capital inflows and increased reliance on domestic savings. The new growth model should pave a way for faster and sustainable convergence to the EU economies. SEE countries still lag considerably behind Western European countries and the more advanced transition countries in terms of the level of income and development. This clearly presents an important task not only of stimulating short-term growth, but also of laying the foundation for the long-term development of these countries, where challenges remain numerous, despite continuous efforts to tackle them.

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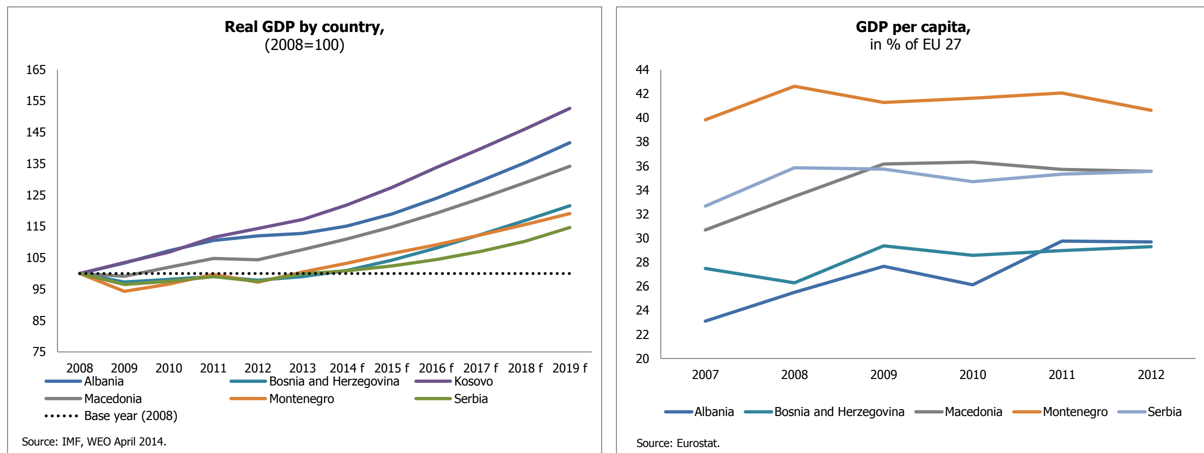
2 Background note prepared for discussion at the Workshop hosted by South East European Studies at Oxford (SEESOX) and the Bank of Albania, in association with the Political Economy of Financial Markets Programme (PEFM) and the European Bank for Reconstruction and Development (EBRD), "Anchoring Economic Policies in South East Europe: the Role of European and International Institutions", 8-9, May 2014, St Antony's College, Oxford.

3 Albania, Bosnia, Kosovo, Macedonia, Montenegro, Serbia.

Chart 1



Has there been a good progress in implementation of the structural reforms in the recent period? Overall, the new Transition Report (2013) does not bring encouraging news along those lines as it points to relatively high number of downgrades at sector and country level indicators. For the first time, the country transition indicator downgrades are higher than the upgrades[4]. However, the downgrades are associated with lower scores in the Central European Countries, most notably in Hungary and Slovakia. SEE countries have sustained their positions in the overall country and sectoral ranking. Looking back at the changes in the ranking since the onset of the crisis (2008) it can be noted that although there was some progress, it was rather slow pointing to delay/sidelining of the structural reforms during a crisis period (Chart 2). As the rankings for the privatization, price liberalization and the opening-up of trade and foreign exchange markets (first generation reforms) are high, main areas which remain substantially below the standard of advanced economies are governance, enterprise reform and competition policy. From a sectoral indicators point of view, the main gaps remain in the area of financial sector (capital markets and private equity), infrastructure and energy sector.

[4] Transition reform 2013, EBRD.

Chart 2: EBRD Transition Indicators

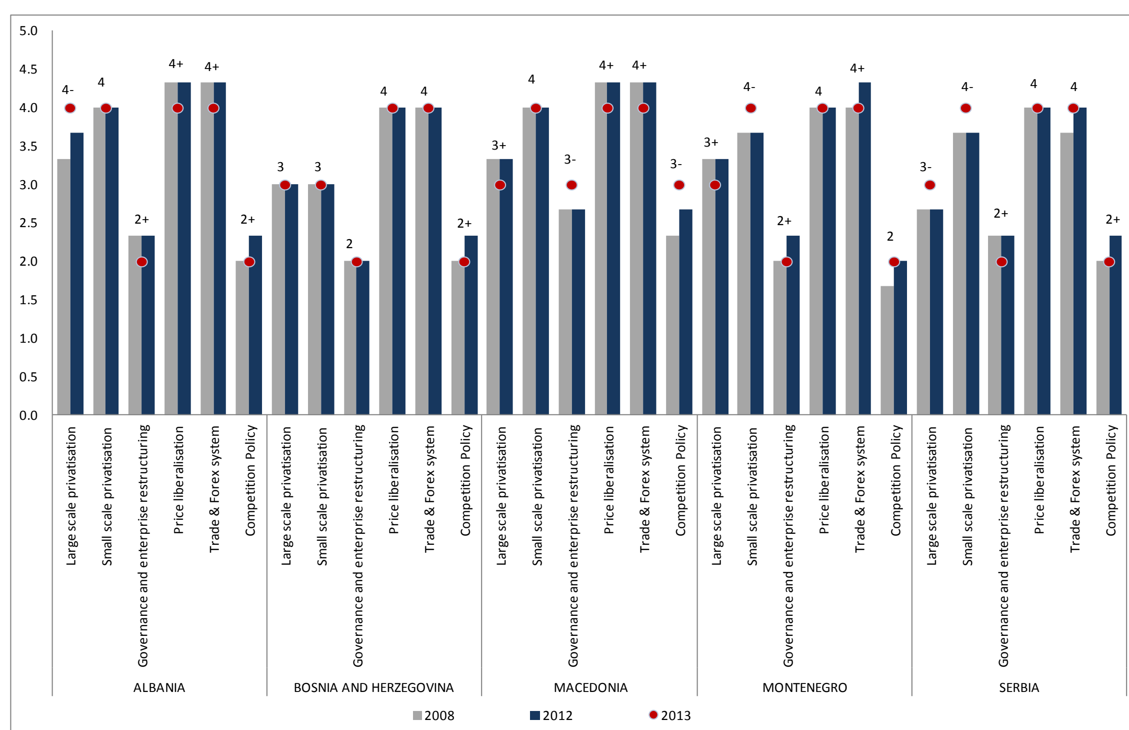


Table 1 Sectoral Ranking, EBRD

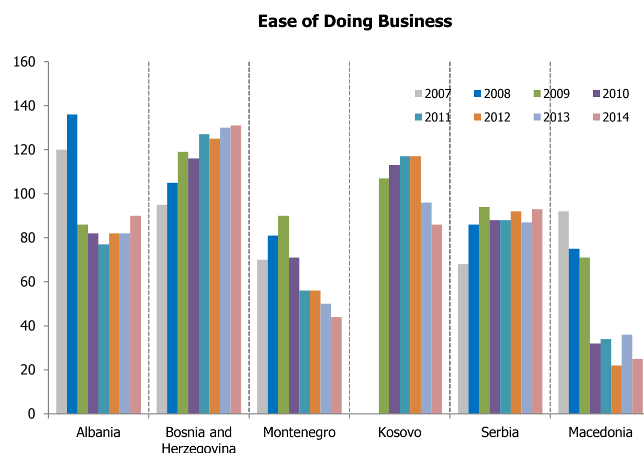
		Albania	Bosnia and Herzegovina	Macedonia	Montenegro	Serbia
Corporate sectors	Agribusiness	3-	3-	3-	2+	3-
	General industry	2+	**2**	3	2+	3-
	Real estate	3-	**2-**	3-	2+	3-
	ICT	3+	2+	4-	3+	3
Energy sector	Natural Resources	3-	**2**	2+	3+	**2**
	Sustainable energy	3+	**2**	2+	**2**	2+
	Electric power	2+↓	2+	3	2+	2+
Infrastructure	Water and wastewater	2+	**2**	2+	**2**	2+
	Urban transport	3-	2+	3-	3	3-
	Roads	3-	3	3-	2+	3-
	Railways	**2**	3+	3-	2+	3
Financial sectors	Banking	3-	3-	3-	3-	3-
	Insurance and other financial services	**2**	2+	3-	2+	3
	MSME finance	2+	2+	3↑	2+	3
	Private equity	**1**	**2-**	**1**	**1**	**2-**
	Capital markets	**2-**	**2↑**	**2-**	2+	3-

Source: EBRD

Notes: The transition indicators range from 1 to 4+, with 1 representing little or no change relative to a rigid centrally-planned economy and 4+ representing the standards of an industrialised market economy.

Given the identified gaps, SEE countries directed their efforts into several main areas: 1/ quality of infrastructure as a key pre-condition to long-term growth; 2/ activities for sustaining structural reforms, where numerous issues appear, with diverse urgency in different countries. For instance, some of the SEE countries have achieved considerable improvement in the business environment and ease of doing business (Chart 3), although the need remains for further work in this area in order to reach levels in Western European peers; 3/ labor market reforms, investments in human capital (health and education), as well as pension funds and general demographic issues. The treatment of all these issues in a satisfactory manner will be essential for improving the long-term growth prospects, taking also into account that the differences among countries imply a need of tailoring country-specific policies.

Chart 3: Ease of doing business for the selected SEE countries



The expected recovery will obviously take place in an environment of repair of public balance sheets. Although most of the countries in the region embarked on fiscal consolidation since 2010, in general, the progress is limited. For most countries budget deficits are higher compared to the pre-crisis average (2002-2008). Large financing needs, elevated debt levels and their rising path, clearly underline the need for further fiscal adjustment. The IMF assessment on public debt sustainability shows that consolidation of the fiscal finances will remain a medium-term challenge for most of the countries in the region. The assessments even point to further increase in the public debt in some of the countries (Serbia, Croatia)[5]. High debt levels present an important source of vulnerability as they entail higher financing needs. External borrowing remains a key source of public debt financing, thus increasing the susceptibility of countries to external financial shocks.

How to design a fiscal consolidation so that it would not affect the still nascent economic recovery in SEE, however simultaneously sending clear signals that consolidation is

[5]For more details see "Fiscal Consolidation process in CESEE countries", Bezhoska at all., background note prepared as a platform for discussion at the BIS Meeting of the Working Party on Monetary Policy in Central and Eastern Europe, Ljubljana, Slovenia on 27-28 March 2014.
http://www.nbrm.mk/WBStorage/Files/WebBuilder_The_fiscal_consolidation_process_in_CESEE_countries.pdf

unavoidable and credible? This takes us to the well-known dilemmas regarding the speed and the composition of the adjustment. Indeed, after initially increasing budget expenditures, SEE countries have considerably brought them back as part of the consolidation process. This, combined with the rigid structure of expenditures, as well as the need for significant budgetary outlays related to structural and infrastructure projects in the medium-term, means that the space for further expenditure-cutting is fairly limited. On the other hand, while revenue levels are considerably lower than in other European countries, their increase might considerably affect the competitiveness of SEE companies, thus affecting the recovery. The institutional capacity to implement the envisaged fiscal consolidation is of crucial importance. The empirical literature points to a positive relationship between the quality of fiscal institutions and fiscal performance[6], although political commitment is essential. According to an IMF Working Paper by Olden at al. (2012)[7], the strength of budget institutions in SEE countries is similar, with most of the countries having an overall score of "moderately strong" institutions. However, the assessment also indicates several deficiencies in the budget planning and execution procedures, pointing towards the need to focus the efforts on improving areas such as macro-fiscal forecasting, analysis and disclosure of fiscal risks, parliamentary scrutiny as well as independent fiscal institutions (fiscal councils).

Besides the general dilemmas related to the fiscal consolidation process, the current juncture brings some specific challenges for the global public finances, but pertinent to the SEE countries, as well. The cycle of monetary easing in the advanced world is probably near its end. This brings out the question about the challenges emerging markets would face during the process of monetary policy normalization**.** Withdrawal of liquidity and rising global interest rate imply higher costs of borrowing. In addition, as advanced world recovers, markets would most probably scrutinize more rigorously the fundamentals of the emerging markets (debt tolerance in emerging world may fade), which may drive the risk premium in this part of the world. This may have adverse implications for the deleveraging of the private and public sector, as well as negatively affect the real sector recovery. Admittedly, global emerging markets have come under pressure again since the beginning of the year, but the countries in the SEE region have been relatively unaffected by the decision of tapering. This might be related to the predominance of the capital inflows that are not interest-rate sensitive in these countries. However, cautiousness should be preserved, especially in those countries that are running large current account deficits and external debt stocks, which they need to finance by borrowing on the international markets. Those will be more vulnerable to QE tapering and the associated volatility. The second "new" challenge is related to the low inflation environment. Inflation is projected to remain subdued in the forthcoming period with risks of entering

[6] See, for example von Hagen and I.J. Harden, 1996, "Budget Processes and Commitment to Fiscal Discipline," IMF Working Paper 96/78; De Haan, Jakob, Wim Moessen, and Bjorn Volkerink, 1999, "Budgetary Procedures — Aspects and Changes: New Evidence for Some European Countries," in James Poterba and Jürgen von Hagen (eds.) Fiscal Institutions and Fiscal Performance, Chicago University Press; Hallenberg M. , Rolf Strauch, and Jürgen von Hagen, 2009, "Fiscal Governance: Evidence from Europe", Cambridge: Cambridge University Press.

[7] Olden B., D. Last, S. Yläoutinen, C. Sateriale, 2012, " Fiscal Consolidation in Southeastern European Countries: The Role of Budget Institutions", IMF WP 12/113.

even negative territory, thus possibly further complicating the recovery and fiscal consolidation process as real debt rises. Given that budget spending is rather fixed in nominal terms, low inflation deteriorates the budget balance. It also complicates the fiscal consolidation as nominal GDP will be lower. Third, in many of SEE countries the current state of accommodative monetary policy and the risk-aversion of the investors provide room for the governments to borrow more extensively on domestic markets, which may act as a potential disincentive for a more rapid fiscal consolidation.

When it comes to monetary policy, the central banks in the region have so far undertaken many conventional and unconventional measures to support the recovery and in most countries, the easing cycle is coming to an end. With the extraordinary loose monetary policy in developed economies being reversed, the pressures for monetary tightening in SEE countries are becoming more pronounced. But apart from the current need to reverse the loosening stance, another more "structural" challenging task for the monetary policy in the macroeconomic constellation will also be to combine the traditional monetary policy objective and the financial stability objective. The recent crisis demonstrated the need for inclusion of financial stability as important goal of central banks and hence, better coordination of monetary and macro prudential policy seems inevitable. In that respect the main challenge would be to devise the optimal mix of both policies, depending on the type of shock hitting the economy. Financial shocks require more active macro-prudential policies, demand shocks require actions by both policies in the same direction, while in case of productivity shocks, conflicts between the two policies might arise. Hence, in this new "mode", for all of the central banks, including those in our region, the challenge in terms of shocks identification and appropriate setting of monetary and macro-prudential policies is of a crucial importance. Of course, macro-prudential tools were used by the monetary authorities in some countries in the region even before the financial crisis hit, and the experiences gained with the implementation of these tools enhances the capacity of policymakers to cope with the future challenges.

Given the absence of alternative financing in SEE, the bank lending dynamics is to be an important determinant of the real sector recovery. Credit flows to the real sector in the region are perceived as subdued. This holds for the credit growth to corporate sector in particular, with the small and medium-size enterprises being particularly affected. Rising NPLs, bank deleveraging and still high risk perceptions amidst anemic recovery are main obstacles to the higher credit support of the real sector. A particular focus should be put on the NPL's in the region, which have risen to unprecedented level in 2013. Although, as for the time being NPL's have not produced major instability problems in the banking system, the loans are well provisioned and the capital of the system is adequate, still containing their growth seems to be an important step towards preventing potential shocks and assuring continual recovery. In addition, it seems we are not out of the bank deleveraging mode, yet. Most banks in the region are part of European bank groups or they are branches of European banks. What happens in the European banking system has ramifications for regional banks, too. The European parent banks, against the backdrop of severe sovereign crisis,

seem to become more risk-averse and seem to have lowered risk-taking in the region. Also, some regulators might have preferred to restrain credit exposure of European parent banks in order to keep domestic financial stability. Therefore, the Vienna Initiative 2 was initiated to tackle precisely some of these issues and to provide ground for a dialogue between international banks, home and host monetary policymakers. On the other hand, if we observe the recent deleveraging process as a logical step after the extreme risk-taking prior to the financial crisis, then the ensuing normalization should be of interest of both creditors and borrowers. Hence, cross-border bank deleveraging will probably continue. "Safety" motive is one of the determinants, and the other one is the increased market and regulatory pressure on some of the European banks present in the region to down-size their activities. "The ECB Asset quality review and stress tests add an additional element of uncertainty".[8] Of course one of the concerns is that the deleveraging process might overshoot, and might turn into an impediment to investment and growth. Yet, on the other hand, policymakers should be aware that putting excessive focus on the credit figures might be in vain during a recovery from a financial crisis preceded by a credit boom. In this setting credit and economic growth are typically less tightly correlated (the so-called "credit-less recoveries")[9] .

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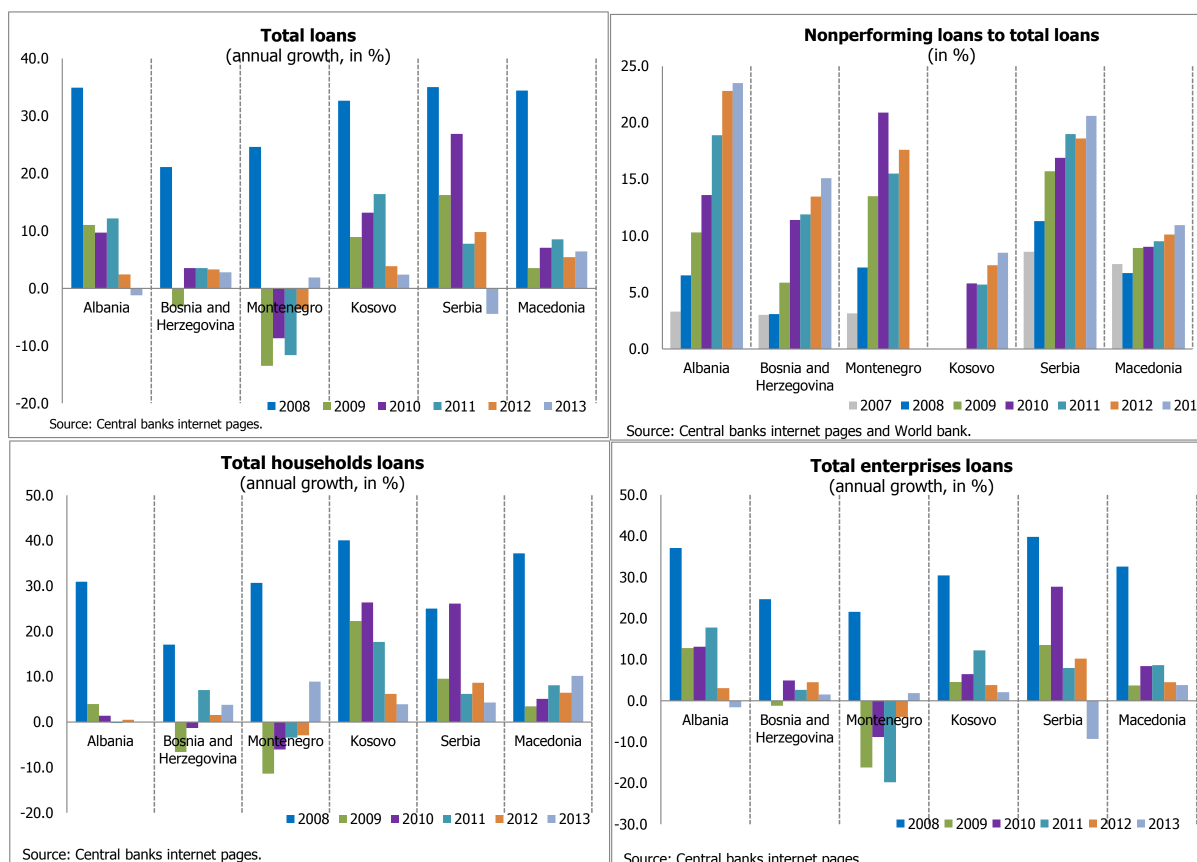
[8] World Bank, South East Europe, Regular Economic Report, May 2014.

[9] E. Takáts and C. Upper, "Credit and growth after financial crises", BIS Working Papers, 416, July 2013

Chart 4



The ongoing global financial regulatory reform might also curb credit growth[10]. The reform process is considered to be inevitable for promoting global financial stability. The regulatory reform is trying to tackle the inefficiencies which came to the fore during the crisis. It is to ensure that sufficient capital and liquidity buffers are provided, on and off-balance sheet risk coverage and excessive leverage are appropriately managed. Despite the insurance of global financial stability, which is beneficial in global terms, the changes in the regulatory framework pose new challenges for the emerging world, SEE countries included, as well. Large international banks might increase their capital or reduce risk weighted assets, which can be translated into lower availability of finance in the emerging world. The new treatment of specialty finance might endanger the growth outlook of the region. The cost of finance in the region could also increase due to inherent inconsistencies in the treatment of sovereign exposures at the solo and consolidated levels. The new liquidity requirements embedded in Basel III Liquidity Framework might not be tailored to the structure, the depth and the liquidity of the financial markets in the emerging markets. Also, a mismatch arises between the de facto stable funding in some of the emerging countries and the funding that is defined as a stable one within the Basel III regulation. In the growth context what has been particularly being stressed is the

[10] For more details see: Speech of Anita Angelovska-Bezoska, Vice Governor of the NBRM, at the Fourth OMFIF Main Meeting in Europe, Ankara, Turkey, 5-6 September 2013 "Financial regulation, implementation and transition effects on emerging market economies". http://www.nbrm.mk/?ItemID=A1D875DB78394443BE9CEA0D1EF72C22

regulatory impact on trade and long-term infrastructure finance, which are considered to be an important source of growth financing in the emerging countries.

In a nutshell, although there are no doubts that the reform process is an important qualitative step forward for the overall financial industry, aspects like the rising cost of finance, restrained credit availability and a more conservative treatment of some important forms of financing for emerging economies, are the most important consequences of the reform being discussed, and they should therefore be seriously addressed.

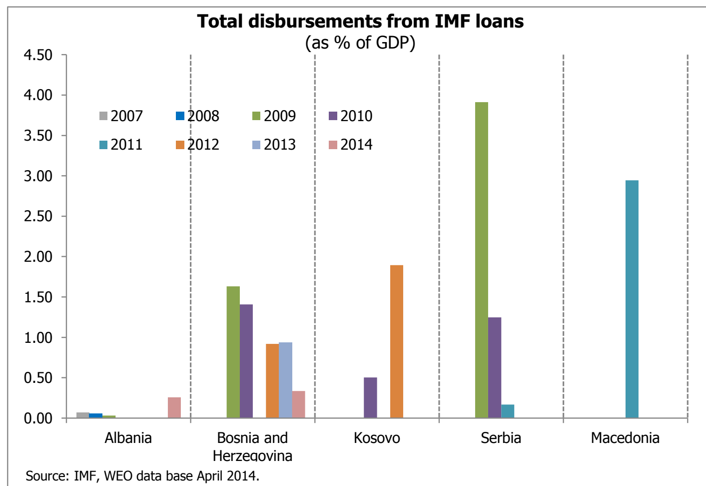
The role of international financial institutions in supporting the SEE region

International financial institutions (IFI's) in the region have always had a pivotal role in underpinning region's efforts towards maintaining macroeconomic stability and pursuing range of reforms for strengthening the capacity for faster real convergence and sustainable growth model. They played a role in disciplining the policymakers and served as a catalyst for foreign private inflows that speeded up the process of transition. The recent crisis also posed challenges for the international institutions asking for reshaping of their activities to mitigate the crisis effects. The IFI's responded to the crisis by better coordination among themselves, regional initiatives, increased funding to the region, new instruments better tailored to the country needs tackling the particularly vulnerable segments, such as financial sector and SMEs, support for preventing abandonment of investment projects, as well as enhanced advisory role.

The **IMF** was present in the region since the early phases of transition, providing financing and policy advice to help countries overcoming balance of payments financing needs, being a catalyst for other official and private flows by giving signals to investors that major reforms are to be undertaken under Funds' arrangements, and providing overall support to countries in the process of economic maturing and acquiring access to financing on international markets. The IMF has responded to the latest crisis with very bold measures. It gave a new flexibility of the framework by establishing new instruments and new guidelines for providing large, upfront financing on a precautionary basis (to deal with the "stigma") and better tailoring conditionality to countries' varying strengths and circumstances. It increased lending access limits (from 200% to 600% of the quota) and simplified terms for borrowing, assuring a better response to the various needs of member countries. Supported by the "new" IMF, the region went through the crisis less painfully. Given the stress at the international financial markets and more difficult access, the IMF financing proved a very important instrument. Macedonia, for instance, got the new precautionary credit line, which gave direct financial assurance and assurance to the financial markets on our strength. Hence, it eased financial constraints in the midstream of the crisis. Other countries in the region, except for Montenegro, have also been supported during the crisis through more conventional IMF arrangements. All these changes mean that now we have an institution that is better tailored to the potential financing needs of its

stakeholders. One additional aspect is the provision of technical assistance aimed at increasing the institutional quality, which so far has served as a very useful vehicle.

Chart 5

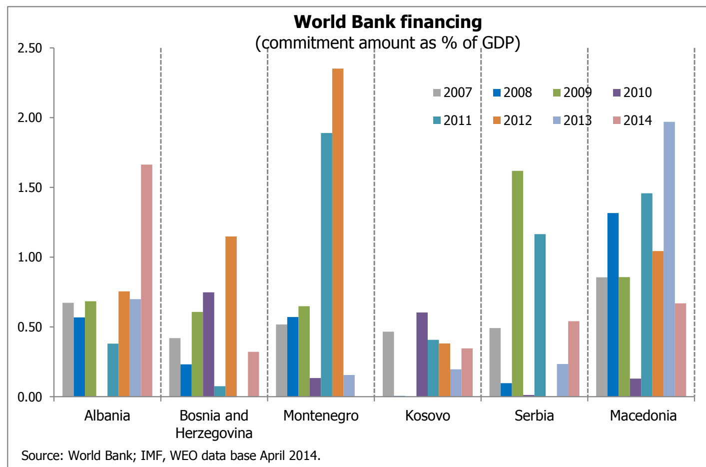


The **World Bank** also played an important role since the beginning of transition by financially supporting structural reforms, in line with its core role. In the crisis period its operations also changed and complemented the ones of the IMF. While IMF supported the most stressed countries, the WB support was more intended to sustain part of the on-going reform processes and was focused more to lower the vulnerabilities of the countries that suffered "moderate" degree of financial stress. These countries faced obstacles—from reductions in exports, growth, employment, and capital flows from abroad - but did not suffer a financial crisis.[11] Thus the Bank's financing through DPOs (Development Policy Operations) covered several sectors with a single instrument (such as DPLs) that was providing support in the fiscal management allowing some of these countries to initiate, to varying degrees, a countercyclical response to the crisis, as it was the case in most of the SEE countries. Currently, and in the following period the Bank remains as one of the major partners in the region as can be best seen through country partnership strategies **-** in a manner that enables continuation of the considerable assistance in key areas such as competitiveness, investment climate, social inclusion, infrastructure and institutional quality. The support will accelerate reforms and is perceived as crucial in the fight to improve the economic outlook in the region. In November 2012, the World Bank, the European Investment Bank, and the European Bank for Reconstruction and Development, announced €30 billion in financing for Southeastern European countries over the next two years – money which could help ease the transition to a more sustained growth in the medium term throughout the region[12].

[11] IEG (Independent Evaluation Group). 2012. The World Bank Group's Response to the Global Economic Crisis—Phase II. Washington, DC: Independent Evaluation Group, the World Bank Group

[12] Source: WB web site

Chart 6



The **EIB**[13] is one of the largest international financiers in the Western Balkans. Over the past ten years, the Bank has financed projects in total of over EUR 7.3 billion in the region, while in 2012 the loans totaled EUR 671 million. While continuing its support for reconstruction and upgrading of the regional and municipal networks of basic infrastructure (transport, energy and the environment), the EIB plans to increase its assistance to the private sector and lend more in health and education sectors in the coming years. The EBRD has been involved actively in this region since the early 1990s and remains one of the largest institutional investors in the region[14]. In 2013 alone, the Bank invested over €1.2 billion in almost 80 projects in the Western Balkans and Croatia, working both with the public and private sectors, and across all the economic sectors - infrastructure, energy, financial institutions – and with foreign and local private companies. The latter includes SMEs, and in that respect the EBRD has recently approved a Small Business Initiative[15]. A more regional approach is also taken for pooling together co-financiers to create regional investment vehicles. An example of such an approach is the new Enterprise Expansion Fund, signed among EBRD, the European Investment Fund and Germany's DEG. This fund is a critical component of a regional Western Balkans SME platform called the Enterprise Development and Innovation Facility. It was launched together with the EU, the EIF, donors and all countries of operations in the region, to provide SMEs with a complete toolbox of financial support, including venture capital, private equity and credit enhancement mechanisms for commercial banks, but also to serve as a comprehensive regional policy dialogue instrument.

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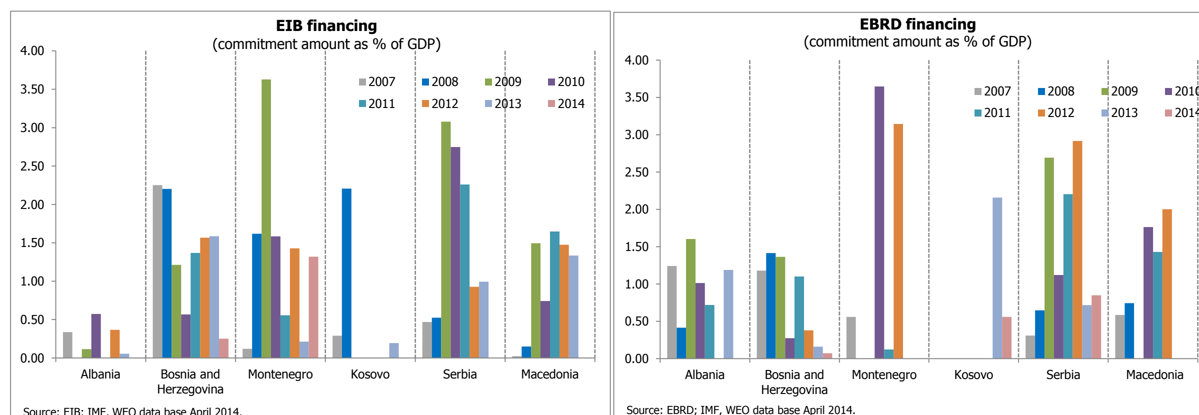
[13] EIB web site.
[14] EBRD web site.
[15] The Initiative is designed to achieve maximum impact by combining financing and policy dialogue at country level, improved coordination between the international financial institutions in this area, and engagement of co-financiers.

Chart 7



While it is more than clear that structural reforms are inevitable for sustainable growth, the impact of the financial and economic crises on the fiscal capacity of governments might postpone or even cancel planned investment, with adverse impact on the region. The main challenge for the international community, and IFIs in particular was to help control the risk, and consider how best to rationalize investment planning; develop appropriate forms of financing (including the mobilization of new funding from home and foreign sources). Hence, amidst the recent crisis, the efforts of the international institution in supporting the region have become more coordinated. The European Commission, the European Investment Bank, the European Bank for Reconstruction and Development, the Council of Europe Development Bank, with the endorsement of EU Member States in December 2009 launched the Western Balkans Investment Framework (WBIF) to finance priority projects in the Western Balkans. The Western Balkans Investment Framework (WBIF) was introduced as a regional tool for EU enlargement. It combines funds from the European Commission's Instrument for Pre-Accession (IPA) with those of IFI's, bilateral donors and the governments of the Western Balkans. The WBIF increases the capacity for infrastructure financing and priority investments in line with accession priorities. An initial focus was put on infrastructure sectors, including social infrastructure, followed by provision of support to small and medium-sized enterprises (SMEs), energy efficiency and other investment sectors. The WBIF is consisted of two key components:

- Joint Grant Facility (JGF), which pools grants from the European Commission's budget, CEB, EBRD, EIB and bilateral donors- for projects likely to be supported by loans from the partner IFIs and other financing partners. Grants have the objective of preparing investment projects, accelerating existing loan disbursement or enabling investment realization by bridging a funding gap;

- Joint Lending Facility (JLF), based on loans provided by CEB, EBRD and EIB and increased cooperation with other multilateral development and bilateral institutions - for investment projects in priority infrastructure and for private sector development.

Looking ahead, development of a new growth model underpinned by structural reforms remains the main challenge for the region. It seems we are all at a juncture where monetary and fiscal stimulus are coming to an end and sustainability of the growth pattern will be to a great deal conditioned on the structural changes that will increase the potential of the economies. Having in mind that the highest gaps are in the area of competition, governance, infrastructure and energy sector the enhanced support of the IFIs in these segments will be of immense importance for speeding up the convergence process. This may require better coordination of the IFIs, further change in the instruments to be better tailored to specific country needs and higher access to finance. In the medium term credit support may continue to be limited given the process of recovery of the balance sheets of the banks and the new financial regulatory overhaul. Required increase in capital and liquidity buffers, is, of course, welcome as it is conducive to higher financial stability, but in the medium-term may pose obstacles for lending and thus have negative implications for the growth. This is particularly relevant for our region where capital markets are almost non-existent. Another challenge is the SSM and its implications for our countries given that cooperation between home and host countries is a key for soundness of the banking system. In this regard, enhanced efforts of Vienna Initiative will be welcomed. The IFIs can help through provision of better targeted credit lines, supporting the consolidation of the banking systems, direct support of the corporate sector, as well as development of domestic capital markets.