“ECONOMIC CONVERGENCE IN SOUTH-EASTERN EUROPE: WILL THE FINANCIAL SECTOR DELIVER?”

By
Valerie Herzberg and Max Watson

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ECONOMIC CONVERGENCE IN SOUTH-EASTERN EUROPE: WILL THE FINANCIAL SECTOR DELIVER?

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Abstract

The pace of financial development in south-eastern Europe has accelerated. In a setting of low inflation and robust growth, domestic credit and cross-border flows are expanding rapidly. This can strengthen sustainable real convergence by supporting productivity gains – thus underpinning higher incomes, enhanced competitiveness and a smooth servicing of external liabilities. But such an outcome is not guaranteed. It depends on a favourable investment climate. Otherwise, an expansion of private consumption and residential investment may not be matched by growth in the traded goods sector and in other productive activities. EU Accession – with its potential for trade and investment integration, and an *acquis*-based strengthening of institutions – improves the chances of good outcomes. But deep structural reforms, as well as sound fiscal and prudential policies, are essential to foster sustainable growth and to avoid financial stress.

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0. Executive summary

Financial sector development is accelerating across south-eastern Europe. Regulation and supervision have been reformed. Bank privatization, frequently to foreign owners, is now widespread. Domestic credit and cross-border flows are rising strongly. This can deepen the productive sector and support real convergence, which are core challenges in the region. But there are also risks – illustrated by global experience in emerging markets and, closer to hand, watchpoints in converging EU Member States. The promise is great; but if the financial sector is to deliver, official policies must assure sound incentive frameworks.

Strong and sustained real convergence requires an expanding financial sector, and sizable capital inflows. But, to be viable, this process must unlock high rates of return in the private sector – triggering productivity gains that build competitiveness, ease adjustment, and assure the smooth service of international liabilities.

In these respects, EU Accession offers unique support. An *acquis*-based strengthening of institutions, and deeper trade and investment links, can jump-start catching-up. But the Accession context also accelerates financial dynamics in the private sector, including through EU-15 bank ownership links and perceptions of a common euro destiny; and this raises the sakes for policy. Moreover, setbacks in the Accession process can fragilise market perceptions and trigger sudden adjustments – with potential costs in terms of real economic convergence.

An important question in this regard is how far the economies of south-eastern Europe resemble or differ from other emerging markets, and indeed how far they resemble each other. Is a synoptic view of the region fruitful? These economies vary widely in political and security contexts, stages of development, and financial maturity. But they have elements in common that suggest a potential for cross-country learning. They have been progressing towards a common goal of EU accession. They share legacies of transition. And they have been experiencing a rapid opening to capital. They also had to address more entrenched problems than earlier EU candidates – and they have scope to learn from these forerunners, whose financial systems are also dominated by EU-15 banks.

A further common feature, now, is the embedding of price stability in almost all of these economies. Fiscal positions are typically under control, although this remains a watchpoint in some cases. Macroeconomic and structural reforms have been inter-linked, given the quasi-fiscal nature of many imbalances, and hard budgets have been fully or mainly imposed. Stabilization has been accompanied by resumed growth; but external deficits in some cases have widened sharply, and private savings are often declining. Credit is rising faster than money demand, and net foreign assets are declining. Some countries have reacted with administrative measures to restrain credit. More fundamentally, there is a question whether savings are being well used.

A key challenge is the difficulty of diagnosing boom-bust risks in a setting where credit, asset prices and the real exchange rate may all be undergoing strong "equilibrium" adjustments. Looking beyond headline rates of domestic credit growth, analysis needs to probe the composition of cross-border and domestic credit and their economic context; the domestic counterparts to current account deficits; the pattern of sector flows and balance sheets; and the pricing and management of risk, including unhedged currency exposures. When it comes to policy responses, the adaptive nature of financial markets means focusing on incentives. A critical question is how monetary, fiscal and regulatory policies interact in influencing markets, and whether the investment climate favours a sustained flow of resources to the productive sector.

The pattern of private sector development has thus moved to centre stage, but the role of the state remains critical as a facilitator – setting incentives, limiting abuses, and ensuring that key infrastructure and networks are in place. In the financial sector, policy incentives can have a systemic impact, powerfully influencing growth and stability. Countries have been recasting the role of the state as it affects this sector, but much remains to be done:

- Enhancing the investment climate through structural reforms. This is crucial for sustained convergence. It means ensuring hard budget constraints on remaining state firms, promoting competitive conditions on domestic markets, and thus setting the stage for vigorous corporate sectors. It also implies addressing weaknesses in judicial systems and regulation that can retard the development of lending to firms, notably of small and medium size, thus biasing credit towards households.

- Ensuring strong macroeconomic and supervisory policies. This means coordinating policies that affect risk-taking – assuring a balanced policy mix that will reduce risks of volatile inflows, and designing fiscal institutions that buttress expectations in the face of shocks. Budgets may need to swing to balance and surplus to offset strong private sector booms. The risk characteristics of monetary regimes deserve attention, including hedging and inflation dynamics under pegs, and limits on the "safety valve" offered by exchange rate flexibility. Supervisors need to internalize systemic risks when evaluating exposures, though not to act as a surrogate for monetary policy.

- Careful analysis of market flows and risk profiles in the public and private sectors. Credit must be appraised in a broad economic context. Vulnerabilities need to be assessed by probing sector flows and balance sheets. One risk is of market crises. But a deeper risk may be of "growth crises" – stress that results from unwarranted real appreciation or heavy balance sheet exposures, which prove hard to unwind. Addressing these risks means probing whether policy frameworks are fostering flexible markets and balanced development in the formal productive sector.

In other words, accelerated financial expansion can support sustained convergence, but this depends on policies. Strong credit growth should not be viewed as inherently suspicious: it is a natural result of declining risk premia and easing credit constraints, one result of which is a sharp "equilibrium" rise in household debt and housing investment. But this could lead to unbalanced development if policies do not also assure a favourable climate for investment in the productive sector, and thus balanced growth.

There may be limited scope to restrain credit or current account imbalances through macroeconomic and financial policies. But this does not mean that policy is impotent. Rather, it underscores the priority of reforms that make it safe to run the economy at high rates of domestic demand, fostering adaptability in the real sector and ensuring strong supply responses. The speed of financial dynamics, in a still evolving institutional setting, highlights the urgency of bold reforms.

1. Introduction

South-eastern Europe[2] faces a historic opportunity of convergence towards average EU income levels. The present paper is concerned with one dimension of that challenge: the role of the financial sector. This is a key issue. The financial sector plays a pivotal role in allocating resources. With pervasive links in the economic system, it can powerfully accelerate real convergence. But the corollary holds. In the wrong policy and market environment it can channel resources towards unproductive projects on a systemic scale that could stall convergence or trigger financial distress.

But there is a question how far it makes sense to look across the region in a single policy perspective. And there is also a very relevant question how far one can draw on experience in central Europe and the Baltics as broadly transferable. Is such an optic warranted?

Like the eastern European EU Member States, south-eastern Europe is a region of transition economies with backgrounds of central planning or social ownership. Banking and monetary policy were combined in a single state-owned monobank, allocating funding across state-owned enterprises without the help of price signals. Romania, Bulgaria and Albania followed the central planning orthodoxy. The western Balkans, except for Albania, operated the decentralised system of social ownership of the former Yugoslav republics.[3]

By the end of the first transition decade, there were advances in the key political and economic conditions that had retarded economic and financial development in the region by comparison with the EU-8. The key economic changes were macroeconomic stabilization and structural reform, following in the footsteps of the central European and Baltic economies. These changes affected first the Eastern Balkans (Bulgaria and Romania) and then, progressively, economies in the Western Balkans (Albania, Bosnia and Herzegovina, Croatia, the former Yugoslav Republic of Macedonia, Montenegro, and Serbia). These developments set the stage for growth to resume on a sustained basis and for financial development to accelerate, first in Bulgaria and Romania and then across the wider region.

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[2] Because of data constraints, the paper sometimes still refers to the joint entity of Serbia and Montenegro.

[3] Interestingly, in former Yugoslavia, a two-tier banking system was however already put in place in the 1960s.

South-eastern Europe has also benefited from the aura of EU enlargement. At Thessaloniki in 2003 the Western Balkans joined Bulgaria and Romania in a perspective of EU Accession. Romania and Bulgaria became members in 2007, while Croatia has begun negotiations, and the former Yugoslav Republic of Macedonia has reached candidate status. The adoption of the *acquis communautaire*, the body of EU law and regulation, is a prerequisite – and this involves importing rules regarding state-aid, competition, central bank independence, public accounting, together with many other framework laws that are important for economic development. In addition, the EU is providing substantial funding to the region, including for reconstruction and stabilisation after conflicts in the Western Balkans.[4]

But there are also key differences, which distinguish especially the Western Balkans from the central and eastern European countries. Importantly, underlying distortions and structural weaknesses could be more entrenched, thus raising financial sector challenges.

The recession at the start of the transition was twice as severe in South East Europe as in central Europe.[5] Berglöf and Bolton (2002) attribute this to repeated bailouts of insolvent and unproductive banks and corporates that followed attempts to stabilise inflation. Macroeconomic and associated micro reforms, including the creation of market-supporting institutions were thus delayed. In central Europe and the Baltics on the other hand governments increasingly resisted the financial pressures, paving the way for restructuring and monetary stability.[6]

The wars in the early 1990s that accompanied the break-up of the Republic of Yugoslavia further added wide-scale destruction of infrastructure and capital stock. They led to a protracted recession, mass population movements and the absence of law and order. Trade patterns were disrupted – notably in former Yugoslavia, where individual republics had specialised along comparative advantages – Croatia in tourism and shipbuilding, the former Yugoslav Republic of Macedonia and Montenegro in heavy industries and metals. During 1990–1995, GDP contracted by an average of 23% each year in Bosnia and Herzegovina and by over 10% in Serbia and Montenegro. Only Albania now significantly exceeds its 1989 GDP level; at the other extreme, GDP in Serbia remains at less than 60% of its pre-war level.

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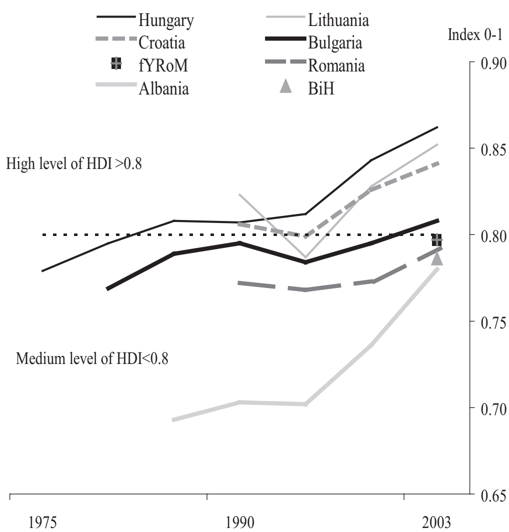
[4] Since 1991, the EU has contributed EUR 6.8bn to the western Balkans. In Bulgaria, the EU pre-accession package reached around 2% of GDP.

[5] See Pissarides (2001).

[6] See Berglöf and Bolton (2002)

Apart from Croatia, the level of human development as measured by the UN HDI[7] is also quite a bit lower in south east Europe than in the new EU Member States (Chart 1). Most countries (except Bulgaria and Croatia) have yet to reach the threshold for entering the category of “high human development”. On the whole, higher education is less diffused and entrenched than in many EU-8 (Chart 2). A large gap historically existed between Albania and the economies in the region, including in terms of poverty, reflecting the isolation of its economy and society until the death of President Hoxha in 1985. In that year Albania recorded the current HDI level of Indonesia or Uzbekistan. Despite the ongoing substantial gap in education attainments, Albania has however significantly caught up in social development (Chart 1).

Chart 1: Human Development Index (HDI)*



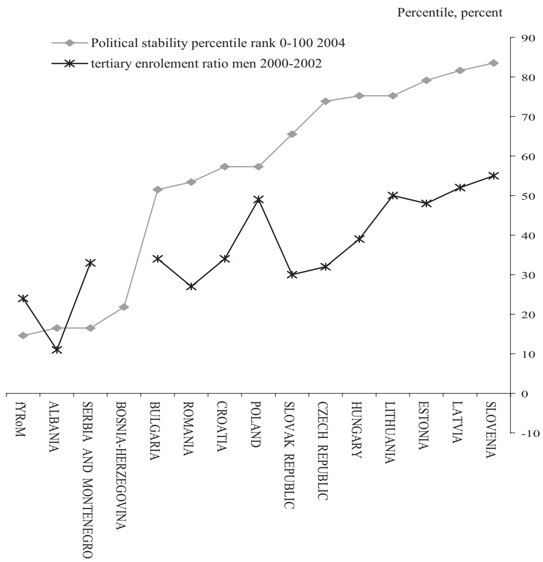
Source: UNDP Human Development Report 2005
* Gaps are due to unavailable data.

Ethnically more diverse than the EU-8, many of the states that emerged from the former Republic of Yugoslavia remain politically fragile. Political stability indicators indeed report a large gap between Bulgaria, Croatia and Romania on the one hand and the rest of the region on the other (Chart 2). Bosnia and Herzegovina is administratively divided into two “entities”, the

[7] The UN Human Development Index (HDI) is a comparative measure of poverty, literacy, education, life expectancy, childbirth, and other factors for countries worldwide.

Federation of Bosnia and Herzegovina and the Republika Srpska, under supervision of a UN High Representative.[8] The ethnic background remains a potential source of tension, and thus political and economic uncertainty. Also, the complex political structure poses challenges for policy effectiveness. While the recent velvet separation of Serbia and Montenegro should relieve tensions, the status of Kosovo in Serbia remains undecided in view of the large Serbian minority and cultural significance. The former Yugoslav Republic of Macedonia also has a large Albanian minority, and has seen periodic interethnic tensions.

Chart 2: Political stability and tertiary enrolment*



Source: UNDP, UN
* Enrolment data for Bosnia and Herzegovina unavailable.

Given the gradual nature of transition, moreover, all countries in the region are still working to address deficits in the institutions needed to support market-based enterprise – notably the enforcement of competition, financial claims, and consumer protection; while governments have not withdrawn fully from productive activity. Meanwhile, the transition to a capitalist system, with its superior ability to allocate resources, has triggered expectations of rising incomes, which could be stronger than warranted in the short term.

[8] Since end 2005/early 2006, the powers of the UN High Representative have been merged with the European Union's Special Representative in Bosnia and Herzegovina.

Both characteristics of transition embed a non-negligible risk of resource misallocation. Leverage through the financial sector, either domestic or foreign through capital inflows, can then trigger banking and currency crises of the kind that occurred in many EU-8 (Poland in 1993, Latvia and the Czech Republic in 1998). Indeed, Bulgaria and Croatia experienced banking crises during the late 1990s, as poorly supervised banks engaged in substantial related-party lending, while individual banks experienced difficulties in Romania and pyramid schemes in the non-banking sector destabilised the economy in Albania.

As difficult initial political and economic conditions are increasingly overcome, but amid still developing institutions, the financial sector is now developing rapidly. Can this be sustained, and how should policymakers respond? This paper will explore in turn the nature of the financial challenges; progress with macroeconomic stabilization; the evolving institutional setting; the investment climate; financial stability issues; and the key priorities and trade-offs for policy.

2. Financial challenges during convergence

The rapid pace of credit expansion in south-eastern Europe has triggered some unease (Table 1). Policy-makers find that their conventional instruments have limited traction over credit growth, and worry that financial exuberance could end in tears, particularly when it is accompanied by widening current account deficits. A key question for the next few years is how far such concerns are warranted, and how polices should respond to ensure that the potential gains from accelerated financial expansion are realised.

Table 1. **S.E. Europe: Real Credit Growth 2000-05 (in percent)**

	2000	2001	2002	2003	2004	2005
Albania	21.7	19.8	34.0	28.0	33.1	70.6
Bosnia & Herzegovina	19.6	38.5	56.9	30.8	33.0	27.6
Bulgaria	5.6	23.4	34.7	44.0	39.6	27.6
Croatia	3.7	18.6	26.1	11.2	10.2	14.3
fYRoM	–16.8	–15.2	27.8	–0.2	9.2	20.0
Romania	7.9	28.0	32.4	56.8	40.5	44.7
Serbia & Montenegro	–55.3	–93.3	34.4	–1.2	48.3	41.0

Sources: IMF and National Publications

Financial development can be strongly favourable for growth, but over time this link depends on policy frameworks that help to foster efficient resource allocation and avoid the vulnerabilities that could jeopardize sustained convergence. Emerging market economies in other regions, and most transition economies over the past decade and a half, have experienced financial crises, which set back economic development. The recent literature on financial development and transition provides valuable background on these issues.

Experience with financial development and transition

The discussion in this paper draws on four strands of literature which are relevant to the role of the financial sector, and which have evolved considerably in the past few years:

- The literature on ***financial development*** finds this accompanying, and almost certainly helping to cause, economic growth – by pooling savings, transforming maturities, spreading risks and overcoming information asymmetries (King and Levine, 1993 a, b and c). Some difficulty in rigorously establishing causality may reflect the fact that accelerated financial growth has often ended in a crisis: the opening to international capital flows has been particularly risky in this regard (Lipschitz et al., 2002). Nonetheless, recent analysis suggests that financial booms may be a key to the process through which superior economic performers emerge: booms help overcome the information problems that impede financing for high-return projects in an immature institutional and market environment. This spotlights the question how to manage accelerated financial development proactively without arresting it or distorting it (Cottarelli et al., 2004; Hilbers et al. 2005). In that perspective, the challenge in south-eastern Europe could be seen as safeguarding stability without "killing the goose that lays the golden egg."

- This highlights the relevance of a second strand in the literature, which concerns ***financial structure***. This was debated during early transition, in terms of Anglo-Saxon versus continental European models of financing and corporate governance. The literature is not conclusive on links between financial structure and growth; but some recent findings are thought-provoking. First, financial structure may change cyclical characteristics in the economy, with more diversified structures amplifying corporate and dampening household cycles (IMF, 2006). Second, some policy practitioners argue that diversified structures add to systemic resilience, providing alternative channels for financial flows in the event of a "credit crunch" (Greenspan). These lines of analysis suggest that the contribution of financial structure may vary from case to case: diversification may help foster sustained expansion where there are concerns about cyclical instability in household debt, and risks of a credit crunch through contagion/common lender effects.

- The literature on ***financial crises*** has grown more complex. Parsimonious Early Warning Systems for foreign exchange pressures, developed following the crises of the 1980s, proved relatively robust and easy to map to policies (Berg et al., 2004). Subsequently, the Asian crisis in the 1990s drew attention to "twin crises" in the external and domestic financial sectors – and in particular to balance sheet risks (Kaminsky, 1997). This highlighted key questions about the channels through which crises affect growth, and also led to greater awareness of contagion and common-lender vulnerabilities. It led to some advocacy of "corner solution" exchange regimes. Indeed, recent experience in Hungary (discussed in Chapter 3) demonstrates the fragility of dual-objective frameworks – namely domestic and external nominal price stability, in the presence of highly mobile capital flows. Another strand focuses on procyclicality in finance – "endogenous financial risk" – with diagnoses based on deviations from trend in credit, asset prices and the real exchange rate (Borio et al., 2001). This work appears highly relevant to the credit booms of Eastern Europe. But it is hard to apply in a setting of economic catch-up, which intrinsically features just such deviations from trend. And it is hard to operationalise in the culture of transparent instrument assignments, since credit, asset prices and the real exchange rate are not the operating targets of any policy or instrument.

- The literature on ***transition*** provides key background to challenges in south-eastern Europe, even though many of these were not command economies. From a financial perspective, a key strand in the literature is the gradual adaptation of the "Washington Consensus" to take fuller account of institutional issues in areas such as privatisation (Megginson and Netter, 2001; Berglöf and Pajuste, 2003). In this respect, transition offered unique opportunities and challenges for financial development. It entailed clean institutional breaks with the past, which was in some ways an advantage; but it also required a sea-change in the role of the state from command to market-based regulation; and there were major hazards in achieving depth quickly in institutional areas such as judicial systems that are critical for balanced financial growth (EBRD, 2005). It typically drew on major inflows of FDI to jump-start investment and improve management; but this process largely by-passed banks and corporate governance frameworks: indeed, investors had little interest in minority rights (Berglöf and Pajuste, 2003). In many cases it was associated with a shock therapy-style embedding of monetary credibility (e.g., with hard peg exchange rates), and sharp falls in risk premia, as well as a rapid removal of credit constraints on creditworthy local borrowers as foreign banks acquired majority stakes in national banking systems. But if the institutional setting for corporate lending was weak, this financial revolution could find its outlets mainly in lending to households (Haselmann and Wachtel, 2006).

The challenge in south-eastern Europe, which brings these strands of literature together, is how to move between two equilibria in terms of financial development in an institutional setting that is still maturing. Political and economic conditions have triggered financial “lift-off” in the region, and this clearly has the potential to enhance sustainable real convergence: but financial deepening raises exposures, and hence the risks of crisis. A key question in this regard is how far the unique perspective of EU Accession – and notably its dual role in catalysing integration and anchoring reform – improves the balance of risks and opportunities in south-eastern Europe compared with other regions.

Assessing the financial sector challenge

The joint impact of financial “lift-off” and EU integration is epitomized by developments in the banking sector. A handful of EU-15 banks have played a catalytic role in transforming financial systems across Eastern Europe. Their contribution was seen as indispensable, importing management techniques and imposing hard budget constraints. Their role in jump-starting the financial sector appears a trump card in Eastern Europe’s convergence strategy. In parallel with FDI inflows, rising bank credit is also emerging as a key medium-term factor driving the import of foreign savings. As credit growth outpaces increases in deposits, the net foreign liabilities of banking systems expand to finance this.

The rapid development in these largely foreign-owned banking systems is one of the most promising aspects of late transition. Nonetheless, there are potential risks in rapid financial transformation. They are illustrated by the experience of integration in Western Europe. Ireland and Portugal, in this regard, represent different ends of the convergence spectrum:

- Ireland attracted foreign savings strongly to the traded goods sector. This was associated with high productivity growth, and helped to underpin real income increases – powering Ireland’s catch-up to EU living standards. This virtuous circle, moreover, was benign for stability as well as growth. It was accompanied, in early convergence, by no more than shallow external deficits, and a mild net foreign asset cycle. Meanwhile, productivity growth ensured that any external shocks could, if necessary, be met with rapid adjustment of the real effective exchange rate. In other words, sectoral patterns in the absorption of foreign savings led to very favourable outcomes, initially, in terms of real convergence, vulnerability and external adjustment capacity.

- Portugal’s pattern of real and financial integration was different. The pace of financial integration was even more striking – a main vehicle being

> heavy interbank borrowing by Portuguese banks. Credit rose steeply relative to GDP. There was a boom in mortgage debt, although the supply response in housing avoided an asset bubble. The public debt, however, also continued to rise. Savings were strongly absorbed in the non-traded goods sector. Productivity growth was disappointing, and the external cycle involved large deficits and a steep fall in net foreign assets. When adjustment had to be faced, in the absence of exchange rate flexibility, this implied that wage growth had to bear the brunt of real exchange rate adjustment, while the fiscal position was not able to cushion shocks. After 2002, real convergence in PPP terms went into reverse.

A simple traded/non-traded goods distinction in this comparison is of course too simple. Non-traded goods that contributed to growth in the productive sector, including the impact of education reforms and infrastructure, played a key role in Ireland's take-off (Box 1).

Box 1: Catching-up, productivity and sectoral allocation: EU Experience

South-eastern Europe has been experiencing a process of rapid financial integration with EU financial markets, typically characterized by sharply declining risk premia and a relaxation of credit constraints on local borrowers. This has been associated with rapid growth in lending to households.

An important question is whether such growth is an "equilibrium" development or reflects distortions in the economic system, as has been suggested at times (Kraft 2005, Haselmann and Wachtel, 2006). A full development of this cycle of integration may be observed in catching-up economies that joined the EU and adopted the euro, which also brought a major decline in risk premia and eased credit constraints. As well as offering close analogies with emerging experience in south-eastern European economies, this is indeed the path that lies ahead for them at differing times in the future.

Recent work by McCarthy, Langedijk, Roeger, Watson et al. at the European Commission has explored this experience and its implications for sectoral investment behaviour during catching-up (European Commission, 2006). One tool used in this analysis is a calibrated New-Keynesian dynamic stochastic general equilibrium model designed specifically to probe the nature of adjustment dynamics in individual euro-area member vis-à-vis the rest of the euro area. The model is based on a stylized economy with three sectors (tradeable and non-tradeable, which in turn is divided into "construction" and "services"), thus distinguishing between "housing" and "non-housing" investment. Financial constraints facing the household sector are explicitly modelled, given the role played by interest rate convergence and the relaxation of credit constraints in a setting of integrating financial markets; and households also display persistent habits in consumption.

Used in combination with time series techniques and selected surveillance-style case studies, this approach suggests a number of interesting common features and contrasts in the catching-up experience of three cases:

- The experience in Ireland illustrates catching up in the classic sense of high productivity growth in tradeables. Capital was attracted into Ireland in the first instance by high rates of return in this sector, which reflected predominantly the availability of human skills (which underpinned the ICT boom). Over an extended period, this pattern of productivity growth sustained competitiveness and generated resources to service Ireland's growingly negative net international investment position. One ripple effect of this process – with a lag – was a housing boom, which then developed its own dynamic.

- In the case of Spain and Portugal, by contrast, productivity growth in tradeables has not been high. Inflation in Spain reflects a Balassa-Samuelson productivity differential, but this is because productivity in non-traded goods was relatively low. Again, capital flowed into Portugal and Spain, of course, because of high rates of return. But these were to a significant degree returns on residential housing. Allocation was quite different from Ireland, and this helps to why Ireland's competitiveness remained high over a long period. In addition, the weak fiscal setting in Portugal tended to weaken competitiveness, and reduced economic resilience when the private sector boom came to an end.

- The drivers of housing activity also differed as between Portugal and Spain. In both cases the decline in risk premia and easing of borrowing constraints were major drivers of the initial housing boom. But the model suggests that these effects should have tapered off after about three years – as they did in Portugal. However, the sustained nature of the housing boom in Spain reflects the additional impact of a migration shock, tourism and demographics, which contributed to continuing housing demand. A notable feature in Portugal, meanwhile, was a strong supply response in the housing sector, which helps explain why there was an asset price bubble.

Thus the allocation of resources as between traded and non-traded goods (especially housing) reflected in part real shocks and resource endowments, as well as the initial decline in risk premia and relaxation of borrowing constraints. Model simulations of the role of these shocks during convergence in Ireland, Portugal and Spain will be found in European Commission (2006). Possible implications for south-eastern Europe are that (1) a boom resource allocation to non-traded goods, and especially housing, is indeed an equilibrium phenomenon; (2) improvements in the investment climate could substantially rebalance resource allocation (including credit growth) towards traded goods, fostering a pattern of growth during catching-up in which competitiveness is maintained even in the short to medium run, mitigating external financing risks; (3) it will be important to achieve strong supply conditions in housing in order to avoid price bubbles and risks of instability (a point also made by Mihaljek); and (4) the management of fiscal policy during credit booms can help safeguard competitiveness.

The broad lesson, though, is clear and centrally relevant to south-eastern Europe today. With declining risk premia and credit constraints, on the back of stabilisation and bank reform, the financial sector is inevitably called on to intermediate a large inflow of savings. How these are deployed will critically affect the longer run outlook for real incomes. It will simultaneously govern the extent of exposure – and indeed of adaptability – in the case of external shocks. These considerations are all the more relevant where, as in much of south-eastern Europe, the nominal exchange rate and national interest rates are not freely available to deal with domestic financial cycles.

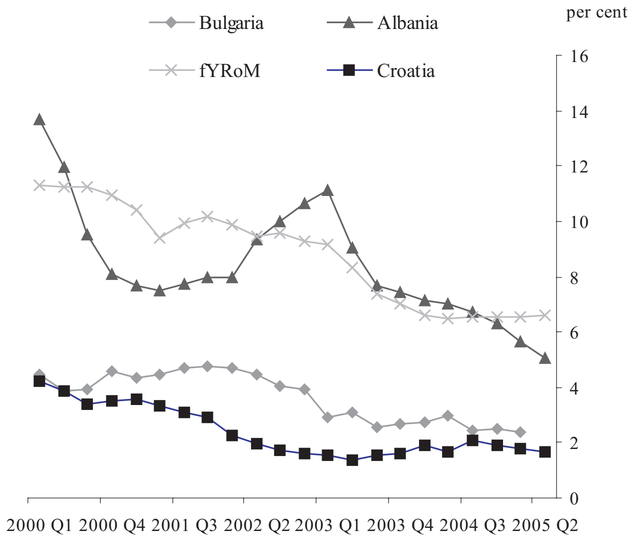
This calls for a prudent fiscal policy to limit economic risks and build resilience – a theme discussed later in this paper. But what deserves particular emphasis is the potential role of the lending environment in influencing risk-return trade-offs across the economy. Structural policies move to centre stage in terms of both growth and stability. The quality of reforms, and the effectiveness of supervision, will be pivotal in any assessment of the outlook for growth, risks and governance in the region. But to set the stage, it is helpful first to review briefly the global conditions in which the financial sector operates today.

The global environment

In addition to the EU dimension, the effects of the global monetary environment on transition economies need to be mentioned. As risk premia became compressed in global developed markets, investors increasingly sought higher returns in more risky markets abroad (‘search for yield’), partly explaining easy access to international markets and significant capital flows to emerging markets. From this the south-east European economies benefited also – resulting in declining returns and yields (Chart 3), which in turn stimulated financial intermediation.

The question for policy, against this background concerns not the underlying financial trends but the risk of distortions or unbalanced financial development. Experience in the euro-12, transposed to the different, but still rapidly integrating, financial environment of south-eastern Europe may suggest three watchpoints in particular. These are, first, that business environments or human skill availability might prove insufficiently attractive for corporate investment; second, that distortions in risk premia (e.g., on unhedged foreign currency borrowing) might trigger misallocation of credit to inefficient destinations; and third, that fiscal policy might not take advantage of booms for accelerated consideration.

Chart 3: Nominal yields in South East Europe



Source: IFS

Dilemmas in diagnosis

If policy-makers are to assure macroeconomic and structural policies that keep financial development on a sustainable path, they must be guided by a correct analysis of current trends. High headline rates of credit growth, rising asset prices, a widening current account deficit, or an appreciating real exchange rate may give little clue whether underlying developments call for "more of the same" or for urgent, corrective policy initiatives. Where developments seem to be moving off-track, a viable medium-term response will require well-informed and coordinated policy action to adjust the incentives facing the private sector. Accurate diagnosis is key.

That means assessing carefully the domestic and external financial dynamics in the economy. This is a complex and demanding task. The convergence setting should inherently be characterised by strong adjustments in the stock of credit, asset prices, and the real exchange rate, as well as the sizable import of foreign savings. It would be easy to mistake these for symptoms of stress, and respond in ways that create distortions (by diverting credit flows) or trigger a setback which, as suggested earlier, might kill the goose that lays the golden egg. Moreover, stress could emerge in various forms, partly depending on the exchange regime. It might not be as an exchange market crisis. It could be as a long period of low growth, if balance sheet exposures in households dampen consumption, or unwarranted real appreciation unwinds slowly under a fixed exchange rate regime. A stalling of convergence could result through either channel. Recent experience in Portugal could be more relevant than Asia or Latin America, and a pro-cyclical fiscal policy could amplify the problem.

How far have developments in risk diagnosis kept pace with these dilemmas? A number of recent papers have assessed the dynamics of headline credit growth in terms of an equilibrium catching-up path, and several of these analyses flag watchpoints in some cases if very rapid credit growth continues. Recent research on financial stability indicators has highlighted also the importance of deviations from trend in credit, asset prices and the real exchange rate, though such analysis is complicated in a real convergence setting (for the reasons noted above). A further relevant tool is balance sheet analysis, which does not predict instability but helps to highlights where shocks could inflict enduring damage on growth. And closely related is the literature on contagion risks, which is relevant in light of the striking "common lender" features in the region. Finally, early warning systems based on exchange market pressure indicators remain an analytical workhorse, bringing together macroeconomic factors, competitiveness measures, monetary indicators, and external balance sheet tests such as the Guidotti ratio. The findings of these studies are reviewed in Chapter 6.

A common feature of such approaches, however, is that they do not probe the composition or credit flows or place them firmly in a real economy setting. Domestic counterparts to the external current account deficit are not really probed, and evidence of policy-induced distortions cannot easily be drawn in. Yet context is crucially important in understanding whether or not expansion in the financial sector is supportive of sustained growth. This requires analysis of credit distribution and its place in overall resource allocation, rather than headline growth rates of total domestic credit. For example, stable real convergence typically features strong resource flows to the traded goods sector. Boosting productivity, such flows foster sustained growth, enhance competitiveness, facilitate real exchange rate correction, and help ensure that negative net international investment positions can be serviced without stress. Developments in credit thus need to be seen in the context of overall sector flows and balance sheets, since the stability characteristics of the economy cannot be determined with respect to any single set of flows. Deeper analysis is timely – though it should be borne in mind that data limitations hamper analysis in several ways (Box 2).

These are, therefore, the main issues that will be pursued in the remainder of this paper. One strand of the discussion relates to the influence of the business environment on credit allocation, and whether this will support growth and competitiveness over the medium term. A second, closely related, concerns financial stability – with a strong emphasis on macrofinancial issues, including the sustainability of current lending booms, and risks that stress could abort real convergence even in the absence of a market crisis. For discussions of macrofinancial sustainability, the prospects for a balanced development of the traded good sector will be important – meaning that stability and growth concerns are, in this respect, particularly closely aligned.

Policy assignment: the issues

The end point of such analysis is to identify how a strengthening of the policy frameworks that influence the financial sector in south-eastern Europe could improve the outlook for sustainable growth. At the outset, therefore, it is important to note the complexity of policy linkages in this regard.

Box 2. Data and Measurement Issues

There are major problems in measuring the scale of total credit growth, its sectoral composition, the terms on which it has been extended, and associated asset price developments.

- Domestic credit is only part of the picture. Direct cross-border credit to non-banks is sizable, as captured in quarterly BIS data for credit to non-banks – most of which is presumably corporate credit. Cross-border intra-company credit is sizable in some cases, and hard to measure. Domestic credit, in turn, is increasingly provided by non-banks such as leasing companies, and here there are not usually systematic data. Overall, credit growth has been under-measured, especially as regards corporations.

- A key issue is how much of domestic credit in foreign currencies is not hedged by the borrower naturally or through derivatives. In Eastern Europe, such flows appear to be very significant in some cases, including in countries with hard currency pegs. Cross-border credit is probably denominated in foreign currencies. Many business borrowers may be hedged, but where survey data is available (e.g., Hungary) this turns out not to be universally true. Households in some cases hold sizable currency assets, but these holdings may not be growing strongly or map to currency liabilities. Better data on the extent of unhedged borrowing would be a very valuable aid to balance sheet analysis.

- Finally, there are difficulties also in tracking asset price developments. Stock exchange indices are available, and in some cases residential housing data. But data on commercial real estate prices are not easily available, and would be key in appraising fragility risks.

Sufficient financial information is available from a range of sources to allow a provisional assessment of efficiency and stability issues. But greater precision would lay the foundations for a more secure analysis of developments, on a case-by-case basis, and thus for a diagnosis on which policy-makers can securely rely.

Financial stability and efficient allocation at the macroeconomic level emerge, in any economy, as the indirect product of successful policy co-ordination. Of course, variables such as credit, asset prices and the real exchange rate are not the target of any instrument; and transparency limits the extent to which they can be factored into decisions. But the major branches of policy affect financial stability and allocation in powerful ways. Stable fiscal and monetary frameworks, with a balanced policy mix; strong supervision; and neutral tax regimes for real estate borrowing are examples of policies that improve the risk environment.

What is to some degree distinctive, throughout Eastern Europe, is the degree to which the freedom of manoeuvre in key policies may be practically limited. Some branches of policy may be tightly constrained. Monetary autonomy, first of all, has been given up in many cases; and in others its latitude is limited by a setting of free capital flows and *de facto* euroization. There can always be scope to tighten fiscal policy; and during financial booms it is easy to overestimate the underlying balance. The allocative impact of fiscal policy can usually be improved, and so – importantly – can fiscal institutions. But public sectors are not always large, and fiscal policy can only be one part of any approach.

In terms of constraints, the supervisory setting also deserves analysis, including the implications of wide foreign bank ownership. This has key advantages in transplanting risk management systems and deep capital resources. But it raises some questions about prevention, in the case of local systemic risks; about funding vulnerability; and about crisis resolution. In operational terms, the systemic prominence of foreign banks, with deep capital and liquidity pockets, limits the traction of local supervisory measures. But this should doubtless be seen as one part only of a wider picture in which there is great scope for disintermediation and regulatory arbitrage. Credit to firms can be switched easily to cross-border routes, allowing household lending to expand domestically; and a tightening of standards for banks can divert credit to less supervised channels.

In sum, great gains from accelerated financial development seem available in these EU-linked economies, but they are not automatic. If, over the medium term, accelerated financial development in south-eastern Europe is to help these small open economies to catch up rapidly, eventually to become 'Balkan tigers', then it is essential to craft macroeconomic and structural policies that harness market-driven bank lending and cross-border flows to that end.

3. The macroeconomic setting

Experience throughout the EU and acceding economies confirms that macroeconomic stability must be entrenched as a basis for sustained growth. To ensure that catching-up is not interrupted by financial stresses, fiscal and monetary policies must no longer be a source of risk. Rather, they must be well-placed to cushion the economy against imbalances that are likely to emerge in the private sector as it enters a period of accelerating expansion.

The past half-decade has seen stability more securely rooted in south-eastern Europe. At the political-economic level, this reflected a growing capacity to come to terms with structural problems in the real economy – which had made it difficult to cut subsidies, raise interest rates, or allow the exchange rate to appreciate as needed. Sustainable macroeconomic stabilization frequently came later than in the Baltic region or central Europe, and this was associated – in a mutually aggravating fashion – with delays in microeconomic reform. Inflation was, to a degree, a structural reform indicator.

Policy-makers have made huge strides in tackling the key transition issues of banking reform; financial discipline in enterprises; and the creation of an institutional framework for market-based growth. Restructuring of unviable sectors or firms may still be ongoing, but hard budget constraints are increasingly put in place. Subsidies are explicit; and where tax or inter-enterprise arrears persist, they no longer imply risks of destabilizing the monetary base, the budget or the banking system. Monetary frameworks are effective, and to varying degrees transparent, in most countries of the region: inflation levels are quite low. Fiscal performance is more varied, but it is strong in some cases, and has typically been improving over time in others – although Romania illustrates currently the risk that renewed pressures for an expansion of fiscal deficits could re-emerge.

Meanwhile, though, the nature of the stability challenge has been evolving. Financial integration has led to the emergence of wide external imbalances in some cases, and it has the potential also to rekindle inflationary pressures (notably under fixed exchange rate regimes). The question now, as the private sector moves into a financial-market supported boom, is what role fiscal and monetary policy need to play in ensuring that real convergence is not interrupted by financial stress. How can fiscal and monetary policy help moderate or counterbalance private sector imbalances as the economy enters a period of accelerating expansion, including notably in domestic demand?

A macroeconomic snapshot

To set the stage, it may be helpful to highlight the key features of macroeconomic performance over the past five years, and its policy foundations.

Economic growth has strengthened across the region (Table 2). The recovery in most cases has been sustained since 2000, and is continuing. GDP in 2005-6 is rising at rates of 5 to 6 percent in Albania, Bosnia and Herzegovina, Bulgaria, Romania and Serbia, and about 4 percent in Croatia and the former Yugoslav Republic of Macedonia. The expansion has typically been led by domestic demand, and thus differs somewhat from the pattern in central Europe, where net exports played a stronger role. It has been accompanied by rising inflows of foreign direct investment. Both consumption and investment have increased, with the balance varying. It is hard to disentangle how far investment growth reflects an upswing in residential construction versus other investment.

Table 2. **S.E. Europe: GDP Growth, 2000–06 (in percent)**

	2001	**2002**	**2003**	**2004**	**2005**	**2006**
Albania	7.0	2.9	5.7	5.9	5.5	5.0
BiH	4.3	5.3	4.4	6.2	5.0	5.0
Bulgaria	4.1	4.9	4.5	5.7	5.5	6.0
Croatia	4.4	5.6	5.3	3.8	4.3	4.6
fYRoM	–4.5	0.9	2.8	4.1	4.0	4.0
Romania	5.7	5.1	5.2	8.4	4.1	6.5
Serbia	5.1	4.5	2.4	9.3	6.3	6.5
Montenegro	–0.2	1.7	1.5	3.7	4.1	5.5

Source: EBRD

Export growth has been relatively strong (Table 3). In 2004, Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Romania and Serbia all achieved increases in dollar export values of 30 percent or more. Generally slower growth rates in 2006 still saw the region’s exports rising by between 10 to 30 percent.

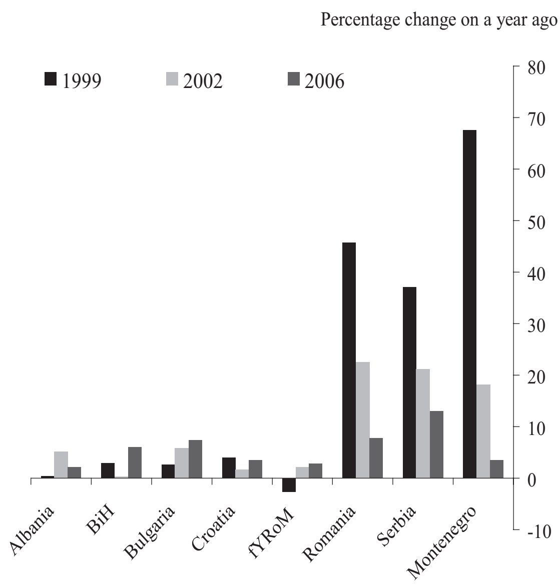
Table 3. **S.E. Europe: Merchandise export growth, 2000–06 (in percent)**

	2001	2002	2003	2004	2005	2006
Albania	19.6	8.1	35.4	34.9	27.0	10.2
BiH	4.6	9.4	36.1	28.3	26.2	17.4
Bulgaria	6.0	11.3	32.5	30.7	18.7	30.0
Croatia	4.2	5.1	26.1	30.1	7.7	–
fYRoM	–12.6	–3.6	22.1	23.0	–4.3	12.7
Romania	9.8	21.8	27.1	33.4	17.0	26.0
Serbia & Montenegro	4.2	20.2	26.6	38.1	30.4	Serbia: 29.1 Montenegro 8.5

Source: EBRD

Inflation had been reduced to low levels in most countries by the end of the 1990s, and in other cases there has recently been a very substantial improvement (Chart 4). Nonetheless, inflation is now a worry again in a few cases, including in some hard peg regimes (such as Bulgaria) as well as flexible regimes (such as Romania). One temporary influence is the impact of energy prices. But a more pervasive source, actually or potentially, is pressure on non-traded goods prices from a rapid expansion of bank credit.

Chart 4: CPI inflation in South East Europe



Source: IMF and EBRD

Low inflation in almost the entire region reflects robust monetary policies, often in transparent regimes designed with IMF assistance. A key feature has been the increasing independence of central banks, underpinned by the EU *acquis* in this area. Even Serbia, where there have been significant macro- and microeconomic difficulties in completing disinflation, has seen a decline from very high levels of price increase since the turn of the decade. Indeed in early 2007, inflation reached a 15-year low of 5.2 percent.

External current account performance has varied widely. Bosnia and Herzegovina and Bulgaria have continued to show very large imbalances. Other countries registered deficits in a range of 5 to 9 percent. FDI more than financed the deficits in Bulgaria and Croatia, and covered two-thirds to three-quarters of those in Albania, Romania and Serbia. Only in Bosnia and Herzegovina and the former Yugoslav Republic of Macedonia was the FDI cover less than one-third (Table 4).

Table 4. **S.E. Europe: External current account balances and foreign direct investment inflows 2004, 2005 (in percent of GDP)**

	2004		**2005**	
	Current Account	**FDI**	**Current Account**	**FDI**
Albania	–3.8	5.0	–6.9	3.4
BiH	–24.4	6.0	–26.6	8.2
Bulgaria	–5.8	5.1	–11.8	10.7
Croatia	–5.4	2.6	–6.3	3.6
fYRoM	–7.7	3.0	–1.3	13.0
Romania	–8.5	6.9	–8.7	8.3
Serbia	–14.8	4.3	–10.0	6.1
Montenegro	–7.8	3.3	–8.6	22.8

Source: IMF, national publications

A distinguishing feature in some cases has been a high level of foreign remittances, which have represented a stable source of income. Between 2000 and 2003, recorded remittances amounted to four times the value of the current account balance in Albania, double in Bosnia and Herzegovina, and more than half in Croatia and the former Yugoslav Republic of Macedonia. Their true magnitude is estimated to be even larger, suggesting that current account deficits are to some extent over-recorded.[9]

[9] See World Bank (2006) and de Luna Martinez, Endo and Barberis (2006).

In most cases, external deficits essentially reflected absorption of savings by the private sector, since fiscal balances in many cases showed a modest deficit or a surplus. Moreover, in Bulgaria and Serbia, and to a lesser degree the former Yugoslav Republic of Macedonia and Romania, the last two to three years have seen sizable rises in investment. Where savings fell, this was also typically a private sector development – and the decline was substantial in Bosnia and Herzegovina and Romania. A different pattern of imbalances was evident in Albania and Croatia, where the public sectors were in significant, though diminishing, deficit.

Eastern Europe, in other words, has bucked the emerging market trend. Where economies in Asia and Latin America run surpluses and build reserves, this region imports savings on a major scale. Geopolitically, that should be no surprise. Eastern Europe is embarked on a historic venture to pool with its neighbours many aspects of economic sovereignty. It is betting on integration, rather than insuring against risks to financial autonomy. As trade and investment links deepened, inward FDI helped drive and finance external deficits. The region's patron has been Schuman, not Guidotti.

Macroeconomic frameworks, institutions and governance

The encouraging economic performance of recent years – resumed growth with low inflation – already evidences greatly improved macroeconomic management. But important challenges remain, especially in the public finances. The challenge now is, to an important degree, to improve macroeconomic governance and related institutions.

In the case of the **public finances**, it is true that headline fiscal deficits and debt ratios have been declining (Table 5). Great improvements have been made also in fiscal measurement: off-budget funds have increasingly been incorporated, and sound public accounting practices have been adopted. Transparency has thus made a leap forward, reflecting the impact of international standards and codes, and the *acquis communautaire*.

But the relative weakness of fiscal frameworks is evident, first, in that fact that fiscal consolidation is incomplete in several cases. Retrenchment in Croatia has proved troublesome, and the high level of public investment expenditure only partially mitigates this concern. Public debt dynamics in Bosnia and Herzegovina remain a major challenge. In Serbia, there is important real sector restructuring still to be completed, and this may throw up further significant costs to the budget. In Romania, 2006 has seen an ill-timed easing of the fiscal stance against the background of a strong private-sector boom. There are still cases where off-budget funds have yet to be fully incorporated. This typically means that deficits in such cases are somewhat under-recorded. And strategies usually are not yet in place to address population ageing.

Table 5. **S.E. Europe: Fiscal balances and public debt ratios, 2000–05 (in percent of GDP)**

	Fiscal Balance		Public debt	
	2000	**2005**	**2000**	**2005**
Albania	–9.2	–4.7	71.3	55.0
BiH	–3.1	0.0	–	30.0
Bulgaria	–1.0	+2.3	89.3	29.9
Croatia	–6.5	–4.2	51.1	45.6
fYRoM	+2.5	–1.5	53.2	44.0
Romania	–3.8	–0.8	22.7	15.2
Serbia & Montenegro	–0.9	+0.2	–	53.0

Source: IMF and National Publications

Second, fiscal policy now faces the challenge of supporting macroeconomic stability in a setting of strong credit expansion and growing private sector saving-investment imbalances. Here, the capacity of fiscal institutions to ensure that "good times" are well used will be crucial. This depends also on accurate measurement of underlying fiscal balances during financial booms, an area in which advanced as well as emerging market economies in other regions have experienced problems (Jaeger and Schuhknecht, 2004).

Fiscal positions tend to be overestimated in an environment of credit and asset price booms for several reasons. Asset price rises can provide a sizable, but reversible, boost to revenues. Moreover, the composition of GDP during credit booms may initially show strong consumption growth, with weak net exports, but over time this tax-rich composition will tend to reverse. Finally, it is easy to overestimate potential growth when a credit boom is underway. At a minimum, a sizable safety margin must be allowed in estimating the underlying fiscal position during financial booms.

Domestic fiscal institutions matter crucially in an environment of strong credit expansion and large private sector imbalances, because they are a vital complement to externally set rules such as the Maastricht criteria for membership of the euro area. It is particularly important, in this setting, to treat the 3 percent Maastricht deficit reference value as a ceiling, not a target.

Experience in Spain, and a comparison with Portugal, illustrates the stabilizing influence of a fiscal policy that moves to surplus during real convergence alongside the process of euro adoption.

If credit booms continue, and growth in south-eastern Europe remains strong over the next few years, it will be prudent to allow the public sector to move to balance or surplus. This will help preserve macroeconomic balance; limit real appreciation; and build in additional flexibility for the challenges that may surface as credit booms come to an end. But if the public sector's support for growth is not to be diminished, then structural reforms in taxation and in public expenditure are a high priority, so that adequate consolidation can go hand-in-hand with growth-supportive spending.

In other words, the institutional and structural features of fiscal policy need to move to centre stage. This is essential in order to combine support for stability with support for growth, and to ensure that sound fiscal institutions help to preserve time consistency in policy and to steer expectations.

Well-targeted reforms hold the key to reconciling support for growth with a pace of consolidation adequate that can safeguard macroeconomic stability. Key steps to raise public saving can also improve allocative efficiency – for example, removing subsidies to consumption and real estate, and making budgets more supportive of growth in the productive sector.

In this context, there needs to be a review of tax burdens and social charges. While tax rates are not out of line internationally, top brackets often start at low monthly incomes, e.g., less than 500 euros. Moreover, social contributions amount to a non-negligible further 40%. In Albania, the top bracket rate of 30% yields revenue collections of less than 1% of GDP. Excessive taxation encourages firms to misreport information or opt for the informal sector, tending to distort credit away from potentially profitable firms.

From a financial stability perspective, microeconomic aspects of fiscal policy deserve much more attention. Key priorities here include public debt strategies (as these affect funding and exchange risks); and the allocative impact of taxes and subsidies, including the treatment of interest on real estate borrowings.

Reforms to the civil service and bureaucracy constitute a major policy priority, especially for small firms, to get rid of corruption, burdensome regulations and red tape. Again these encourage informal sectors – and hence render formal financial intermediation more difficult. This is indeed a key issue – and one where the EU accession perspective can most help in its resolution.

In the broader public sector, the restructuring of state-owned firms and hardening of budget constraints remains incomplete in some cases, especially in the Western Balkans. This is crucial in order to cut back budgetary subsidies – and in a few cases to help avoid a build up of further NPLs in the banking system, as well as a diversion of credit away from private firms.

There is important scope to strengthen fiscal institutions, thus helping to embed stability more firmly and to influence market expectations (Box 3). In particular, strategic medium-term frameworks for public spending can help support a reorientation toward productive goals.

Box 3. Fiscal Institutions – Lessons from the "2004 Wave" of EU Member States

There are interesting lessons to be learned from fiscal experience in eastern EU Member States. A key insight is that the institutional setting of policy can influence expectations favourably through sound governance, transparency, credibility and time-consistency – thus enhancing stability. There are several facets to this issue, and they are relevant to south-eastern Europe.

For many of the Member States that joined the EU in 2004, a key challenge is to build credibility with markets that they can hold firm to **budgetary commitments**, overcoming the "common pool problem." Fiscal institutions can be designed in ways that help limit expenditure bias – a topic examined in European Commission Public Finance Report for 2005. There are different approaches. One is to delegate formation, monitoring and implementation of the budget to a single body – for instance, a finance minister with a leading role in the budgetary process. A further approach is to address fragmentation of the process by increased co-ordination among spending ministers and different levels of government through formalised rules and procedures. Most of the Member States that joined the EU in 2004 have embarked on reforms in their fiscal institutions that embody elements of the latter approach.

In recent years, most of these countries also introduced **multi-year budgetary frameworks** to internalize medium-term consequences of decisions on spending, and improve ex-post monitoring.

Many also moved to integrate activities of **extra-budgetary funds** in the budget process, and to increase co-ordination of spending decisions across levels of government (Gleich, 2003, Yaoutlinen, 2004). It is important not to create sources of public debt outside the budget through a failure to control tightly the incurring of contingent liabilities through public-private partnerships.

The ending of regulatory uncertainty was identified as a major constraint-for example in relation to privatisation. It is thus important to draw up a credible **medium term reform plan** to anchor expectations – this would encourage firms to borrow for investment and productive activity. Independent councils could be called on to prepare the macroeconomic assumptions used in budgetary projections. Effective regulatory frameworks can allow the private sector to play a role in providing infrastructure.

Nonetheless, there is still room to strengthen fiscal governance in these countries, particuarly in light of the "reform fatigue" which (as in the Czech Republic, Hungary and Poland, for example) can easily set in after periods of strong adjustment effort. For example, agreement how to use better than expected **budgetary outcomes in "good times"** will be helpful to avoid loosening the stance of fiscal policy during periods of strong growth. Such a rule might be to dedicate all over-budget revenues to deficit and debt reduction, thus building a buffer during good times.

Strengthened practices for **evaluating expenditure** (e.g., via cost-benefit analysis techniques in the selection of projects, periodic reviews of programmes, establishment of selected output-based indicators) also contribute to increase the effectiveness of expenditure and to achieve cost savings.

A key element of all such approaches is **sound and transparent fiscal data**, following ESA 95 principles, provide policy-makers and markets with a reliable basis for assessment. Effective fiscal management needs to rely on a range of indicators, not just a few headline numbers, and to incorporate key consistency checks in accounting areas such as stock-flow adjustments – as well as economic areas such as the compatibility of projections for sector balances in the economy.

Source: Expands and updates European Commission (2005)

In **monetary policy**, strong and transparent institutional frameworks (hard pegs or inflation targeting) are in place in several cases, while others have intermediate approaches. This reflects in part the diverse approaches adopted during stabilization episodes, which tended to move countries and entities towards the two ends of the floating/hard peg spectrum.

A first group (Bosnia and Herzegovina, Bulgaria, Kosovo and Montenegro) opted for deutsche mark/euro-based stabilization strategies through hard pegs or introduction of the euro without a formal arrangement, and are continuing with this. A second group also used the exchange rate as the main instrument to stabilize prices, but without a hard peg: Croatia and the former Yugoslav Republic of Macedonia remain in this category. A third group (Albania, Romania and Serbia) pursued eclectic strategies – informal inflation targeting (IT), managed floats or monetary targeting. Romania has now moved to a pure form of IT, while Albania and Serbia have been moving pragmatically and prudently in this ultimate direction. There has thus been some tendency to move further toward "corner solutions," though not all cases fit into this pattern.

But in the case of monetary policy, quite complex structural and institutional challenges remain, over and above the attainment of fully transparent policy regimes. As well as their effectiveness in containing inflation, all of the prevailing monetary regimes also have important risk characteristics, in terms of overall economic and financial management. It is essential for fiscal and structural policy-makers to internalise fully the implications of these differing regimes and institutions for risk management and policy co-ordination, if financial development is to be sustainable.

These risk characteristics are well illustrated in the present environment of rapidly growing domestic credit and widening private sector imbalances. There are difficult questions how monetary policy can or should respond, within the limits of each regime type, to the impact of expanding credit on the external accounts and on asset prices. These problems take somewhat different forms depending on the monetary regime.

Under hard peg regimes, with an open capital account, there is little scope to influence credit through interest rates. Moreover, the fixed exchange rate setting may contribute to a willingness among firms and households to take on unhedged foreign currency debt, facilitating more rapid credit growth. Hard peg strategies may thus encourage, overall, an acceleration of financial dynamics. The influence of the exchange regime should not be exaggerated: expectations of medium-term nominal appreciation could have a similar result. And there are deeper processes of financial integration at work. But patterns of credit growth lend some plausibility to the role of the exchange regime (Table 6).

Table 6. **Eastern Europe: Monetary regimes and credit developments (in percent)**

	Monetary regimes	**Real credit growth (2005)**	**Foreign currency credit % (2005)**	**Credit/GDP (2004)**
Albania	Float	70.6	80	9
BiH	CBA	27.6	Indexed	45
Bulgaria	CBA	27.6	45	37
Croatia	Rigid	14.3	65	62
fYRoM	Peg	20.0	40	23
Romania	Float	55.0	65	18
Serbia & Montenegro	Rigid, both cases	41.0	70	17
Czech Rep.	Float	19.6	11	32
Estonia	CBA	57.5	73	42

Hungary	Rigid	14.7	39	44
Latvia	Hard Peg	35.5	60	51
Lithuania	CBA	52.5	58	29
Poland	Float	8.5	24	31
Slovakia	Float	21.8	38	24
Slovenia	Rigid	20.2	32	48

Sources: IMF; National Publications

With adjustable pegs, which are represented in the region (formally or informally), there are well-known problems of vulnerability to speculative attacks. A familiar risk is that fiscal policy may fail to underpin the peg, and that external funding of the public sector may add to financial vulnerabilities. Second, market perceptions may switch abruptly from a conviction that monetary policy will dominate fiscal policy, leading to an abrupt reversal of the exchange rate. In Eastern Europe, Hungary offers a clear example of policy mix and communication problems (Box 4). The impact of exchange rate dynamics on the real economy will vary according to whether balance sheet risks have build up in the form of sizable unhedged foreign currency exposures – a plausible by-product of pegged regimes.

Box 4: Financial market developments and macroeconomic policy in Hungary in 2003 and 2004

In the run-up to EU membership, Hungary attempted to pursue a twin strategy of targeting both internal and external price stability. But a lack of consistency and transparency in the macroeconomic policy mix confused financial markets. In essence, the confusion stemmed from tensions in the authorities' strategy of targeting the inflation rate and exchange rate simultaneously. These tensions were aggravated by a pro-cyclical stance in budgetary policy (including sharp increases in public sector wages), which generated inflationary pressures and threatened a loss of external competitiveness. The government's commitment to economic growth motivated a devaluation in the forint vis-à-vis the euro (June 2003) in an effort to underpin net export performance. The devaluation surprised the markets and, by implying that competitiveness takes precedence over inflation control, contributed to sustained currency weakness thereafter (Chart A). The central bank (MNB) struggled to maintain the exchange rate within its unofficial target range of HUF 250–260 per euro.[10] Forward exchange rates followed the spot rate, but spreads between the two widened, indicative of a market expectation of further exchange-rate depreciation (Chart B). However, forward indicators of exchange rates must be treated with some caution. Uncertainty about policy objectives and the associated above-average volatility in the forint exchange rate (Chart C) may have also resulted in higher risk premia.

[10] The official fluctuation bands were of +/-15% between 324.71 forint/euro and 240.01 forint/euro.

Meanwhile, the MNB raised interest rates from a trough of 6.5% in January 2003 to a peak of 12.5% in November 2003, in an attempt to meet its inflation target of 4.5%.

Chart A: Forint/ Euro spot and forward exchange rates

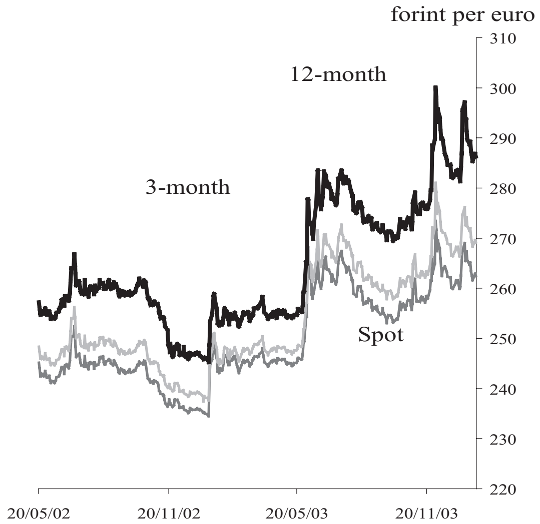
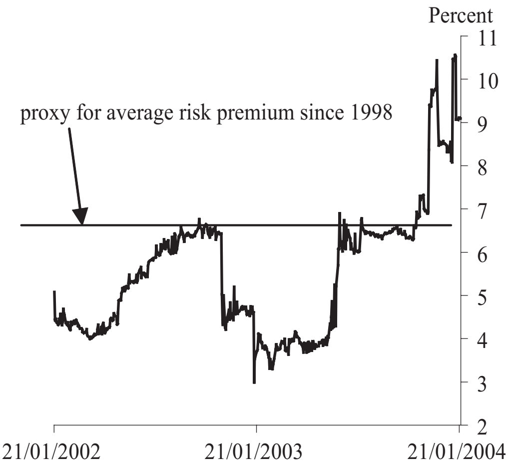


Chart B: Spread between 12-month forward and spot forint/euro rate



Problems in the macroeconomic policy framework prompted a re-evaluation of the expected euro adoption date by the authorities and also by financial markets. Spreads between implied Hungarian 5-year swap forwards and equivalent euro yields at the 5-year horizon (i.e. expected 5-year interest rate spreads in 5 years time) widened to around 200 bps from around 100 bps during 2003 (Chart D). Implied future spreads would not have widened and would probably have been considerably lower, if euro adoption in 2009/10 (and/or nominal convergence) had been 100% credible (with zero uncertainty), For example, the corresponding spread for Belgium and Portugal against Bund yields hovered around 40–50 bps in the years immediately before euro adoption in 1998 (Chart D).

Chart C: 30-day rolling volatility of the forint/euro exchange rate

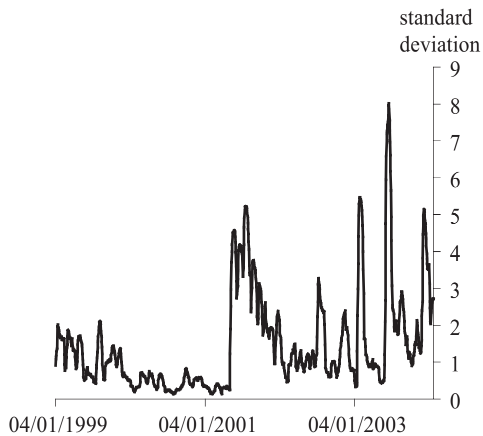
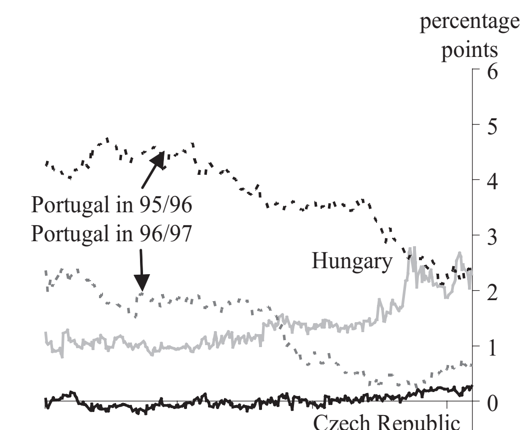
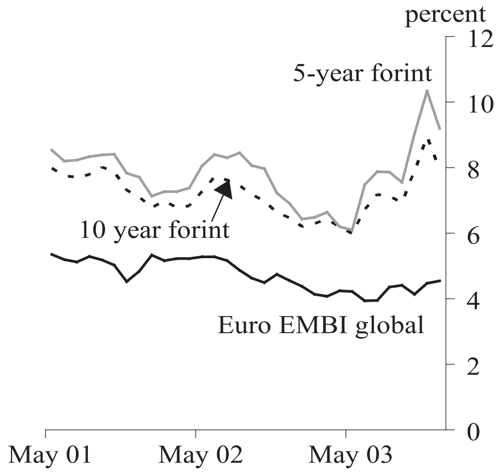


Chart D: Spreads on implied 5-year swap forward rates in 5 years time



Despite developments in yield spreads, the financial-market view of Hungary's credit risk were not adversely affected by these events. The steep rise in local-currency bond yields can be attributed to higher foreign exchange risk premia (linked to anticipated further depreciation in the forint) and higher inflation expectations. In contrast, however, euro-denominated yields remained at low levels (Chart E). This divergence in domestic and euro yields would suggest that investors were discounting adverse exchange-rate movements but were less concerned by the risk of outright default.

Chart E: Sovereign bond yields



Fixed and floating strategies, moreover, channel shocks to different markets, so the resilience of the economy will vary according to the flexibility and rigidity of those markets. Under pegs, real sector markets need to be flexible (labour markets, and other mechanisms that reallocate resources, such as insolvency procedures). Under flexible rates, financial markets need to adjust flexibly to avoid major and durable losses of output – and this will not be the case if firms and households have large unhedged balance sheet exposures.

The time-profile of adjustment to shocks, also, is different under floating and fixed exchange rate regimes. Under flexible exchange rates, monetary policy has the freedom to puncture a credit boom. Under hard pegs, country-specific booms lead to adjustment through an extended process of real appreciation, which over time slows the boom. There is a perverse effect, initially, as inflation rises and real interest rates fall – amplified by asset prices. So the boom may be protracted. There is a question whether such extended periods of perversely low real interest rates may cause a distortive shift of resources to the non-traded goods sector, also retarding adjustment. And there is also a concern that periods of inflation in such booms could postpone a "euro exit" just when external vulnerabilities are largest.

These regime differences are important, but the degree of policy flexibility under floating rates should not be exaggerated. Monetary sectors in the region are quite small and euroised, so the impact of interest rates may be modest, and unsterilised inflows may dilute their impact. The response of the economy to exchange rate shifts is also complicated by unhedged currency exposures (depreciation becomes potentially contractionary, and appreciation can be expansionary due to balance sheet effects). This means that puncturing a boom may involve a sharp adjustment in interest rates, exchange rates and output.

In the setting of south-eastern Europe, with credit accelerating and private saving-investment imbalances widening, these risk characteristics of monetary regimes take on key importance. Flexible regimes with rising levels of foreign currency debt offer only qualified monetary autonomy, and provide only a limited "safety valve" for policy errors. Hard pegs initially proof the economy against speculative attacks. But they may accelerate the growth of credit and unhedged exposures; and their inflation dynamics could delay euro adoption – factors that leave these regimes exposed to a small risk of a major crisis, were a peg to fail amid heavy balance sheet exposures.

This assessment carries strong messages as regards economic governance and institutions. First, it is crucial to assure transparent and credible macroeconomic policy frameworks, and strong institutions, to help steer expectations and safeguard stability. Second, the financial expansion underway in the region implies a very heavy discipline on the robustness of fiscal and prudential policy and the effectiveness of structural reforms: risk management in the economy has to be broadly shared across policies. Third, flexible monetary regimes may help to address some aspects of credit expansion (including allocative issues and the prevalence of unhedged borrowing), and they may serve as a safety valve for policy slippage. But, fourth, these advantages of flexible regimes are likely to be diluted over time, while the "disciplining" influence of floating rate regimes on other policies has so far been weaker than that of hard pegs in much of eastern Europe.

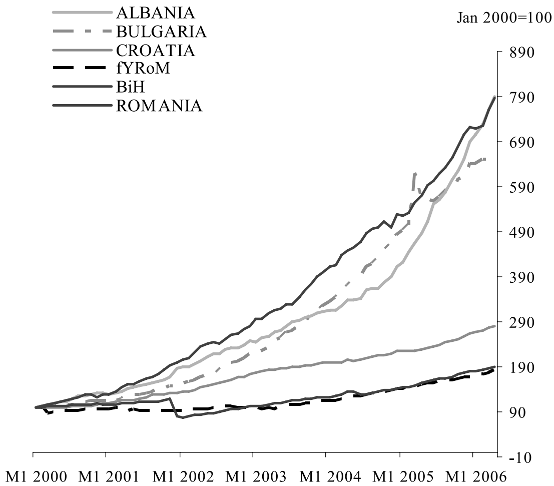
4. The emergence of market-based financial systems

During the 1990s, financial systems in south-eastern Europe went through a period of protracted crisis. State ownership and soft budget constraints, coupled with close links to inefficient state-owned enterprises (SOEs), resulted in a build-up of non-performing loans. As monetary overhangs and liberalisation triggered rising price levels, policymakers' attempts to control inflation failed when interest rate hikes put pressure on firms and threatened insolvencies. Renewed rounds of soft lending (or bail-outs of inter-enterprise arrears) often followed, causing further misallocation of credit at a higher eventual cost to society. Meanwhile, liberal bank licensing regimes and weak regulation encouraged the creation of many small banks, often set up by credit-constrained private sector industrialists. Connected lending was widespread.

As macroeconomic stabilisation policies eventually prevailed – in some cases, such as Bulgaria, abruptly through currency boards or euroisation – full-blown banking crises frequently followed. This had the potential to trigger disintermediation and heavy financial losses, as in Bulgaria (1997) or Croatia (1998/1999). Montenegro had only one bank operating in late 2002. Albania faced a severe financial crisis in 1997, although this erupted from pyramid schemes in the non-bank financial sector. In Kosovo, as Yugoslav banks left the province during the conflict, the formal financial sector ceased to exist. Given the volatile environment and perceived risks, no private commercial bank, local nor foreign, was willing to open in Kosovo.

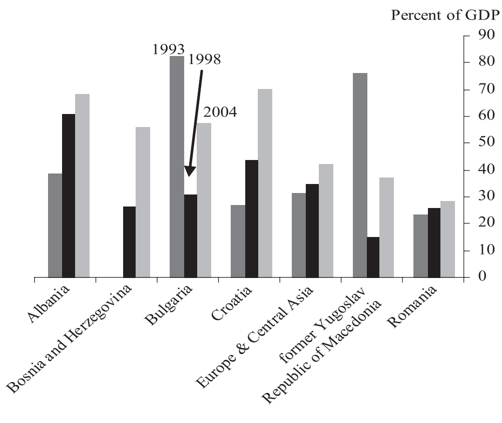
Since then, however, the region has made substantial – often dramatic – progress in reforming and modernising financial systems. Growing confidence in banks has been reflected by rising credit penetration and deposit growth (Chart 5 and 6). Private sector credit has grown by between 10% and 70% annually since 2003 (Table 1).

Chart 5: Domestic private sector credit



Source: IFS

Chart 6: Liquid assets (M3)



Source: WDI
* data for Albania for 1993 is from 1994

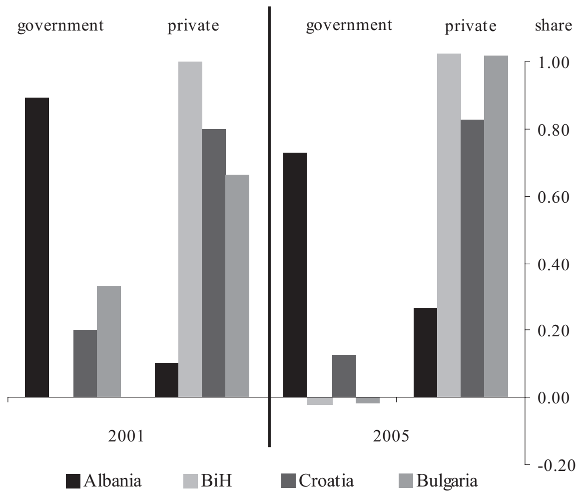
More rapid financial expansion can be traced in part to economic stability. Evidence from a panel regression suggests that macroeconomic factors are indeed important in determining banks' asset allocations in south-eastern Europe (see Box 7). Except for Albania, fiscal consolidation has curtailed banks' exposure to governments (Chart 7). This has increased competitive pressures in private sector lending, put pressure on margins and spreads

(Chart 8) and fostered lending to households, where margins are higher. In Croatia for example, interest rate spreads on household loans are double those on corporate loans, even though they are now beginning to decline (Table 7).

In addition, monetary stability allowed banks to attract cheap household deposits, as a main funding source. However, as credit expansion outpaces deposit growth, banks are increasingly switching to foreign borrowing and market instruments to sustain asset growth. In Bulgaria, foreign borrowing as a percent of bank assets has risen to around 18%, from some 5% a few years earlier (Chart 9).

Also, exchange rate targets, pegs or currency boards have lowered perceived exchange rate risks. With a positive wedge between local and foreign currency interest rates, demand for foreign currency credit has shot up, notably in Serbia, Croatia and Bulgaria. (To some degree this may also reflect implicit hedges, such as exports by firms and remittances to households.) It is interesting to note that the adoption of inflation targeting in August 2005 in Romania promoted a shift away from foreign currency, but this respite seems to have been temporary (Chart 10).[11]

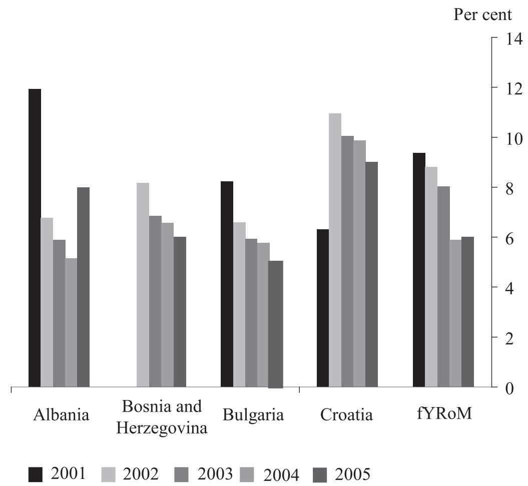
Chart 7: Banking sector claims on government and private sector



Source: IFS

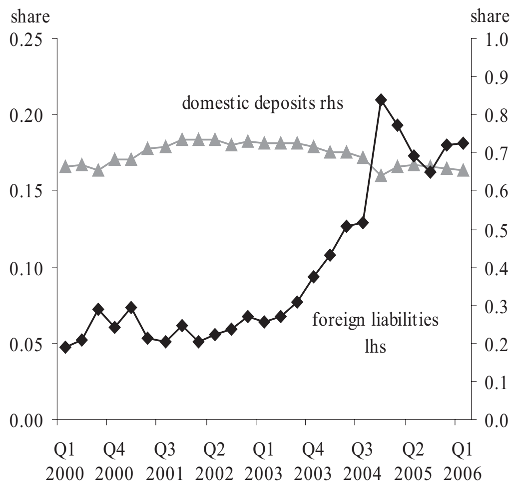
[11] Chart 10 displays local and foreign currency denominated lending. Given the availability of FX-indexed loans, the true size of FX lending is likely to be broader than suggested in the chart.

Chart 8: Interest rate spreads in South East Europe



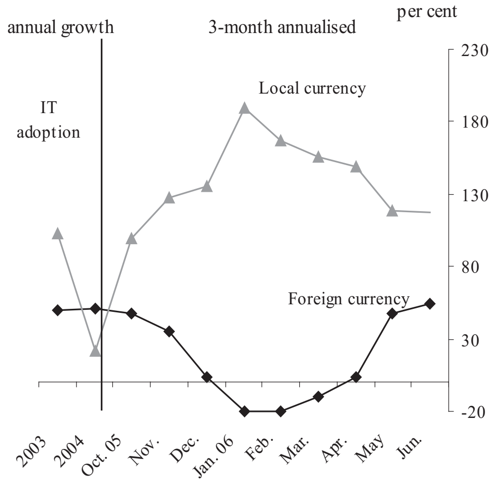
Source: WDI

Chart 9: Foreign liabilities and domestic deposits as share of banking sector assets – Bulgaria



Source: IFS

Chart 10: Credit growth to non-government sector – Romania



Source: National Bank of Romania

Table 7: **Croatia: Analysis of interest rate spreads, 2001–2003 (Percentage points)**

	2001			2003		
	Total	Enterprises	Households	Total	Enterprises	Households
Interest spreads	9.6	4.8	13.7	7.2	4.9	10.1
Overhead costs	3.5	3.5	3.5	2.5	2.5	2.5
Loan provisioning	0.1	0.1	0.1	0.4	0.4	0.4
Reserve requt.	0	0	0	0.2	0.2	0.2
Deposit protection	0.5	0.5	0.5	0.4	0.4	0.4
Pre-tax profit	5.6	0.8	9.7	3.7	1.4	6.6
Tax	0.2	0.2	0.2	0.1	0.1	0.1
Profit margin	5.4	0.6	9.5	3.6	1.3	6.5

Source: IMF

In most cases, the state privatized banks, and opened the sector to competition (Table 8). The state share declined across the region to around 2–8%. Only in Serbia, the government through its largest bank still controls some 24% total assets. Privatisation involved banks mostly domiciled in the EU (notably Germany, Austria, Greece and Italy), with market shares now of 51–92%. These changes had several implications. They increased efficiency, as new technologies and know-how weeded out inefficient banks, creating economies of scale and reducing overheads. In addition, parent relationships facilitated external borrowing via intra-group funding.

In parallel, financial sector regulation and supervision were modernised to provide a stable and efficient framework for privately-owned intermediaries. Payment systems are well-functioning. Supported by IMF FSAP recommendations, banking laws were modernised in line with best practice, and most countries are increasingly compliant with the Basle core principles of supervision. Prudential rules were tightened, and increasing pressure was placed on banks to build effective risk management systems and monitor credit and market exposures.

Table 8. **Structure of the banking sectors in South East Europe, 2004/2005**

	Number of banks 2005	*Market share % 2005*			
		Foreign-owned banks	Private domestic banks	State-owned banks	Top five (2004)
Croatia	34	91	6	3	74
BiH	33	91	5	4	61
Bulgaria	34	75	23	2	55
fYRoM	20	51	47	2	76
Romania	33	60	33	7	60
Serbia	40	66	10	24	–
Albania	16	92	0	8	77
Montenegro	10	88	7	5	–

Sources: Mihaljek; EBRD

Stricter regulation and greater competition led to closure of poorly managed and often family-owned small banks, enhancing economies of scale. Better governance in some economies also boosted stock markets. In Croatia, for example, the new law on securities markets brought the obligation to list all companies with 100 shareholders or more and at least around euro 4 million share capital. Overall, though, corporate governance remains a major challenge throughout south-eastern Europe.

Clearly majorly progress has been achieved in the last few years. The joint impact of macroeconomic and microeconomic reforms has made the banking sector deeper, more profitable and more resilient (Table 9 and Chart 11). Croatia's banking sector has nearly reached the standards of a fully working market economy (Table 10). Apart from where government ownership remains significant, systems are on the whole well capitalised and able to withstand unexpected adverse shocks. Profitability is strong, thanks also to high asset quality, although increased competition has started squeezing margins, encouraging continuous innovation and market development.[12]

Table 9: **Banking sector robustness indicators in south-eastern Europe**

	Return on assets (before tax)	Net interest margin (% of assets)	CAR %	NPL/Total %	Loan-loss provisioning as % of NPL
Albania	1.3	–	20.8	1.1	
BiH	0.6	–	18.5	2–4	Mostly
Croatia	1.7	3.1	15.8	4	58
Bulgaria	2	4.8	15.2	2.2	49.2
Romania	1.7	3.6	20.2	2.6	55.1
Serbia	19.8	6.2	25.2	22.5	47.8
fYRoM	1.6	8.2	20	15	–

Based on a variety of sources and referring of different dates (2002–2006) (IMF, national central banks, EBRD). Detailed comparisons across countries should therefore be avoided.

IMF FSAP stress tests suggest that in most countries banks are able to withstand the direct effects of exchange or interest rate shocks. More questionable, however, is the degree of resilience vis-à-vis the indirect effects of currency shocks through lending to unhedged borrowing. The non-bank financial sector also still stands on more shaky grounds (Table 10), despite some progress made in 2006 in a number of economies, as noted by the 2006 EBRD Transition Report (e.g., Bulgaria, Croatia and the former Yugoslav Republic of Macedonia). Insurance and pension funds suffer from ongoing governance and supervision weaknesses, insufficient size, lack of competition and openness and skill shortages.

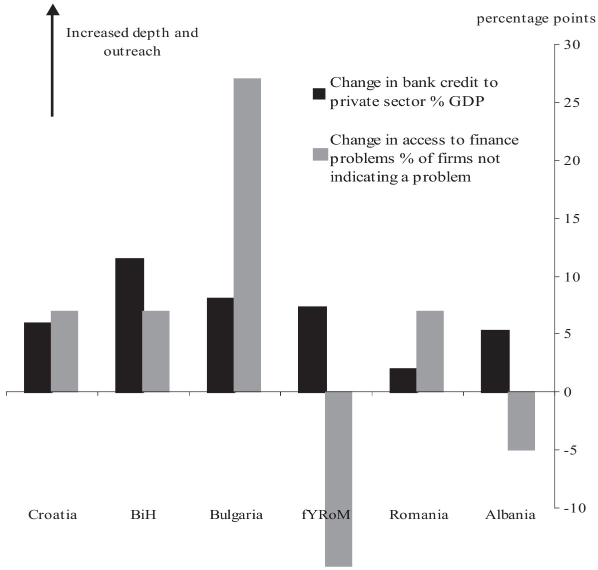
Table 10. **EBRD indicators of financial sector reform 2006**

	Bank	*Non-bank*
Albania	3–	2–
Bosnia and Herzegovina	3–	2–
Bulgaria	4–	3–
Croatia	4	3
former Yugoslav Republic of Macedonia	3–	2+
Romania	3	2
Serbia	3–	2
Montenegro	2–	2–

The transition indicator ranges from 1 to 4+, with 4+ representing the standards of an industrialized market economy and 1 no reform.
Source: EBRD

[12] In Serbia, profitability and asset quality is pulled down by the weight of state-owned banks and private domestic banks whose NPLs are between 30-50% of total.

Chart 11. Change in financial depth and breadth in South East Europe 2002–2005



Source: EBRD

These advances that have taken place in the reform and supervision of banking systems are a necessary but not sufficient condition for a strong development of the private sector economy. Clearly, there is a pent-up demand for housing and consumer loans. Risk premia have been falling; constraints on credit availability have eased; and on the side of households permanent income expectations doubtless have begun to rise after a period of economic – and in some cases political – instability. Banks have been moving quickly to establish strong market positions in this potentially quite profitable sector.

But it is less clear that the shift in credit availability has strongly benefited commercial activities, including development of the traded goods sector. Indeed, in the 1990s the contribution of the financial sector to growth was modest. Mehl et al. attribute this to numerous banking crises, and poor governance and asset allocation, largely related to weak institutions and rules.[13] 10 to 15 years later, the impact of the sector on activity through lending to households is larger. By contrast, weaknesses and constraints in the real economy seem still to constrain the growth of commercial credit.

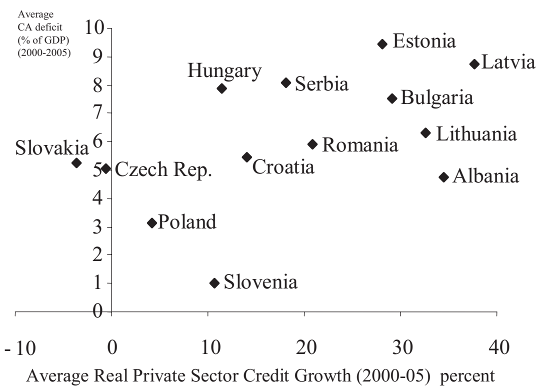
[13] See Mehl, Vespro and Winkler (2006).

In the 2005 EBRD/World Bank Business Environment Enterprise Performance Survey (BEEPS), for example, nearly 70% of responding firms stated that they did not apply for a loan because it "was not needed", suggesting that the real economy is indeed a constraint to financial development. Moreover, despite macroeconomic stabilisation, the cost of financing (e.g. interest rates and charges) was considered a problem for over 55% of respondents in south-eastern Europe, more than in any other transition region. There is evidence to suggest that financial deepening in some countries, such as the former Yugoslav Republic of Macedonia and Albania, has not been accompanied by greater outreach (Chart 11).

The profile of development across the region thus underscores how salient it is to ask whether credit is flowing to uses that will underpin sustained real convergence – and, if not, where policies can be strengthened to foster more favourable outcomes.

A first reality check is to inspect the data across the broader region of Eastern Europe, and ask whether rapid financial sector growth and strong imports of foreign savings seem to go hand-in-hand with favourable real sector performance. This may also help place the economies of south-eastern Europe in perspective by situating them in relation to EU Member States, where reforms typically moved ahead more quickly. The charts shown below attempt to shed light on this, so far as data limitations allow.[14]

Chart 12: Current Account Deficits and real private sector credit growth



[14] Charts 12 and 13 are reproduced from DG ECFIN Occasional Paper 26, with acknowledgement to the associated research work by Caroline Ko.

Chart 13: Productivity and investment growth

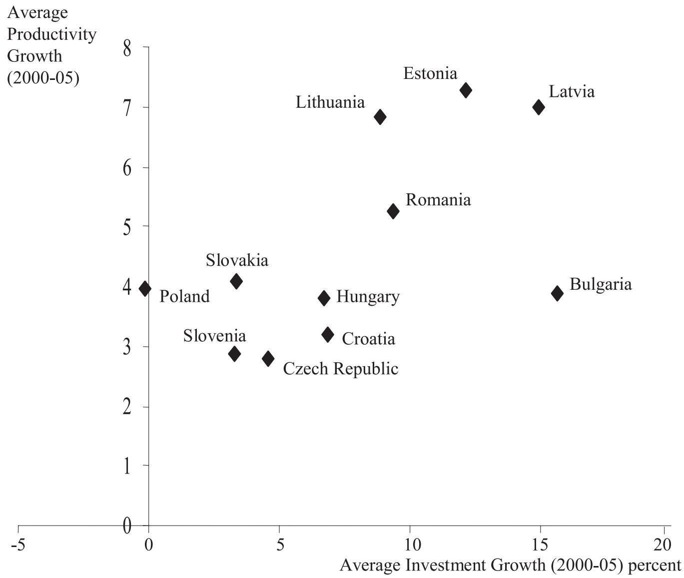


Chart 12 illustrates which countries have experienced particularly rapid credit growth and wide external current account deficits over the past five years. Chart 13 portrays how these same economies have performed in terms of investment and productivity growth. This is a crude approach – included because investment does not distinguish between traded and non-traded goods. But the results are quite suggestive.

Overall, the eastern Member States that have experienced the highest investment and productivity growth include some of those which also have the widest current account deficits and the most rapid domestic credit expansion. The scope for favourable outcomes is evident in some Baltic and central European EU Members. Among these economies, there are examples to show that domestic bank lending can play a greater (Estonia) or lesser (Slovakia) role among financial flows, including foreign direct investment, that support economic development.

But there are specific questions about credit growth in the EU-8, even in the most impressive cases, and these questions are highly pertinent in south-eastern Europe. To what extent is strong investment growth benefiting mainly construction and other non-traded goods, and is this laying a base for sustained growth? Is lending biased toward households (Table 11) or distorted on a systemic scale by poor exchange risk assessments in the case of unhedged borrowers? And could the expansion of mortgage borrowing and consumer debt signal future unsustainable pressure on the balance of payments over the short or medium term?

Table 11: **Eastern Europe, Selected Cases: Real Change in Credit to Households (In percent)**

	2000	2001	2002	2003	2004	2005
BiH					33.5	29.0
Bulgaria	7.5	40.6	40.2	76.5	64.7	50.8
Croatia	15.6	24.3	38.9	23.7	14.9	17.0
fYRoM			34.0	–	62.4	41.6
Romania		56.0	120.4	218.4	49.0	61.0
Czech Rep.	5.0	8.7	26.6	31.9	29.1	30.3
Estonia	22.3	27.0	36.0	52.9	43.7	64.0
Hungary	–	34.5	58.9	53.5	19.5	22.2
Latvia					64.6	72.3
Lithuania	–13.1	24.0	70.2	11.5	94.1	81.9
Poland	14.1	8.9	6.5	12.8	9.3	19.4
Slovakia					27.2	27.4
Slovenia	3.5	–0.3	0.3	5.5	16.8	23.0

Source: National publications

There is nothing surprising about a sharp expansion in household debt, accompanied by rising imports and a shift of resources into the non-traded goods sector – especially residential investment. As noted above, the decline of risk premia and the market penetration of EU-15 banks have released financing constraints on households.

Indeed this amounts to a major and potentially positive convergence shock, involving a rapid adjustment of credit stocks and borrowing levels towards a new equilibrium. Euro adoption had an analogous impact in the converging economies among euro area members, such as Ireland, Portugal and Spain, though the overall pattern of resource flows across sectors led to differing outcomes in terms of real convergence.

In addition to local stabilisation and reform, and the Accession perspective, the effects of global liquidity and international market risk perceptions, as discussed earlier, also have been a factor. As real and nominal yields became compressed in international markets, investors increasingly sought higher returns in more risky markets abroad (the "search for yield"), partly explaining easy access by, and sizable flows to, emerging markets. Moreover, Eastern Europe is far from the only area where easy financing conditions have been associated with a rapid growth in household borrowing, including mortgage debt. To this extent, credit developments across Eastern Europe are also part of a global financial pattern.

The pace of lending to firms has been slower across all of Eastern Europe, so far as available data allow the composition of credit to be analysed (Table 12).

Table 12. **S.E. Europe: Real Change in Credit to Firms (in percent)**

	2000	2001	2002	2003	2004	2005
BiH					28.9	29.0
Bulgaria	5.1	20.5	20.5	21.0	4.4	8.1
Croatia	–2.8	14.9	17.2	0.8	5.5	11.1
fYRoM			–8.3	–	15.2	12.7
Romania		10.1	22.5	34.9	24.0	18.8
Czech Rep.	–13.2	–30	–19.4	–1.3	4.7	12.5
Estonia	38	5.4	5.6	22.6	37.7	51.9
Hungary		0.4	0.6	14.4	6.1	10.3
Latvia					29.6	39.0
Lithuania	–3.9	17.7	23.0	50.9	25.2	39.2
Poland	1.5	–1.6	–0.9	1.8	–7.2	–1.5
Slovakia					13.3	37.9
Slovenia	10.7	13.5	3.8	10.8	15.7	19.1

Source: Central bank reports; IMF

The picture is more complex than it seems, however. Credit to firms has often been growing from a higher base, so it has been more important economically than the growth rates suggest. It is also misleading to evaluate domestic bank credit in isolation from cross-border flows and non-bank intermediation. In some cases, cross-border credit flows have also been very sizable relative to GDP, and these are mainly allocated to firms (Table 13). The scale of jumps in cross-border lending to firms in some cases – Bulgaria in 2004, Croatia in 2005 – also illustrate the scope for resourcing credit in response to measures to restrain domestic borrowing.

Table 13. **Eastern Europe: Cross-border loans to non-banks, stocks, 2000–05 (% GDP)**

	2000	2001	2002	2003	2004	2005
Bulgaria	2.7	1.7	2.3	2.2	6.3	7.1
Croatia	11.0	8.4	11.4	12.2	13.1	21.4
Romania	4.4	4.8	5.0	4.7	5.8	5.7

Czech Rep.	6.0	6.3	6.2	7.3	6.7	6.9
Estonia	5.3	5.9	6.8	6.0	6.6	8.9
Hungary	7.8	7.1	6.4	7.2	6.9	8.3
Latvia	1.6	1.4	1.8	2.4	2.2	3.5
Lithuania	4.7	3.6	2.9	2.9	2.7	2.7
Poland	3.5	3.5	4.0	4.8	4.4	4.4
Slovakia	8.3	6.6	5.6	4.4	3.7	4.6
Slovenia	7.3	7.3	8.7	8.0	7.2	10.5

Source: BIS

It is therefore instructive to compare the pattern of domestic and cross-border bank loans, by sector, scaled relative to GDP. This is a major corrective to the pattern that emerges from domestic claims alone. Currency adjustment is not possible, but a simple presentation can illustrate how the sectoral allocation of bank loans differs if cross-border loans to non-banks are added to domestic corporate lending. These data, scaled relative to GDP, are shown in Table 14. Croatia is a particularly striking case.

Table 14. **Eastern Europe: Credit to firms and households, stocks, 2005 (% GDP)**

	Households	Firms	Crossborder (C/B)	Firms plus C/B
Bulgaria	16.5	26.4	7.1	33.5
Croatia	35.4	30.2	21.4	51.6
Romania	7.5	12.4	5.7	18.1
Czech Rep.	14.1	17.9	6.9	24.8
Estonia	32.8	30.5	8.9	39.4
Hungary	17.4	26.2	8.3	34.5
Latvia	32.4	27.5	3.5	31.0
Lithuania	13.2	22.5	2.7	25.2
Poland	14.6	13.1	4.4	17.5
Slovakia	11.5	11.9	4.6	16.5
Slovenia	15.0	38.7	10.5	49.2

Source: BIS

These figures illustrate that country experience has varied very considerably, and that the scale of bank lending to corporations is easy to underestimate. In addition, direct cross-border flows to non-banks include foreign direct investment, which has been strong in some cases. So resource flows to firms have been larger than it may seem.

In some cases, nonetheless, the recent trajectory of loan growth to households remains a striking feature (as per Table 11). This suggests also a possibility that the strong investment data shown in Chart 13 could in some cases reflect high levels of residential investment, which is socially desirable but does not directly build the productive base of the economy. This split in investment is often not available in national data, however. One interpretation (Kraft 2005, Haselmann and Wachtel 2006) might be that EU-15 banks, in their eastward expansion, are seeking strategic stakes in market segments that are ripe for development. Where business environments are not attractive, mortgages and consumer credit will *de facto* dominate. This bias may be replicated in cross-border flows, if direct investment opportunities are unappealing.

Microeconomically, such a pattern could make sense, though with some question whether exchange risk assessments may be blunted by fixed or steadily appreciating nominal exchange rates. But at the macroeconomic level, a pattern of financial development strongly biased to households could fail to build the productive base of the economy in line with rising income expectations, competitiveness needs, or debt servicing commitments. Banks might end up with concentrated sectoral risks, and there could be a risk of asset price bubbles where housing supply responses are weak.

Moreover, in the event of problems in one country, there would be the potential for these to spread through ("common lender") contagion among the EU-15 banks that are the majority lenders in the region. Financial trends in Eastern Europe have led to warnings about potential risks (Cottarelli et al. 2004, Lane and Milesi-Ferretti 2006).

Such risks might not emerge as a foreign exchange market or banking crisis. They could take the form of balance sheet stresses that weigh on the process of real convergence. The experience of aborted financial development in Portugal illustrates this type of "growth crisis." The fact that stress takes the form of slow growth, rather than a market crisis, in no way allays concerns about damage to real convergence, even though risks of contagion and loss of credit market access may be lower.

In sum, the recent data on domestic credit growth in south-eastern Europe raise at least as many questions as they answer. The apparent dominance of household lending is misleading to some degree, once cross-border and non-bank flows are taken into account. But the extent of flows to productive activities is hard to determine from the data, and probably varies considerably in light of opportunities for private sector development. Romania, for example, emerges as experiencing a combination of rapid financial expansion, high investment and strong productivity growth. But this trend remains to be confirmed, and the data in most cases in south-eastern Europe do not yet indicate as clear a favourable picture.

Meanwhile, the role of the financial sector during convergence in EU Member States such as Ireland and Portugal underscores the message of wider global experience with the impact of financial development on the real economy: the balance of opportunities and risks has depended on the extent to which resources flow to productive sectors of the economy, in a sustainable economic setting. The role of sound macroeconomic and prudential policies, here, is evident. But in south-eastern Europe, it is the effectiveness of structural reforms and, particularly, the depth of institutions, that deserves special attention in this regard. For the recently joined Member States in south-eastern Europe – Bulgaria and Romania – and for actual and potential candidates in the region, this underscores the need not only for macroeconomic stability but for continuing and far-reaching structural reforms to improve the business environment and investment climate.

5. Enhancing the investment climate

In terms of headline GDP growth, south-eastern Europe appears to have reached a turning point in the first half of this decade. Qualitatively, however, some economies display features that need to be addressed to assure sustained catch-up. Productivity gaps, except in Croatia, are large; and in the former Yugoslav Republic of Macedonia, Albania or Romania they may not be offset by lower real wages (Charts 14 and 15). Moreover, productivity growth appears to be, apart from Romania, relatively modest (Chart 14). The private sector is less developed than in central Europe and the Baltic states – its share fluctuating around 50–60%, compared with around 80% in these EU Member States (Chart 16).

Recent progress notwithstanding, the network of SMEs appears to be growing only slowly. Data for 2001/2 showed a density of SMEs per 1000 inhabitants from 7 in Bosnia and Herzegovina to 27 in Bulgaria. This compares with some 80 in the 3 largest economies in central Europe (Chart 16). Informal sectors, which tend to limit bank lending, are large in the region, estimated at over 30% of GDP.[15] FDI has been quite heavily concentrated in the financial sector. Despite the small size of economies, intraregional trade is underdeveloped. In 2003, only 7% of trade in the Balkans was regional, compared with 14% in the Mercosur area or 20% among ASEAN economies.

What factors are constraining the attractiveness of the region as a production centre, and hence the transfer of capital and know-how to stimulate growth?

Despite past reforms, the weakness of private sector activity is still partly due to unrestructured SOEs that continue to capture and waste resources (Table 15). Except for Bulgaria and Romania, the shedding of productive assets held by the public sector remains incomplete, notably for large enterprises. Even Croatia is still endowed with some non-negligible loss-making SOEs, for example in heavy industries such as steelmaking and shipyards, which benefit from state guarantees. In Bosnia and Herzegovina around 60% of SOEs and a similar share of voucher-privatised firms report losses.[16]

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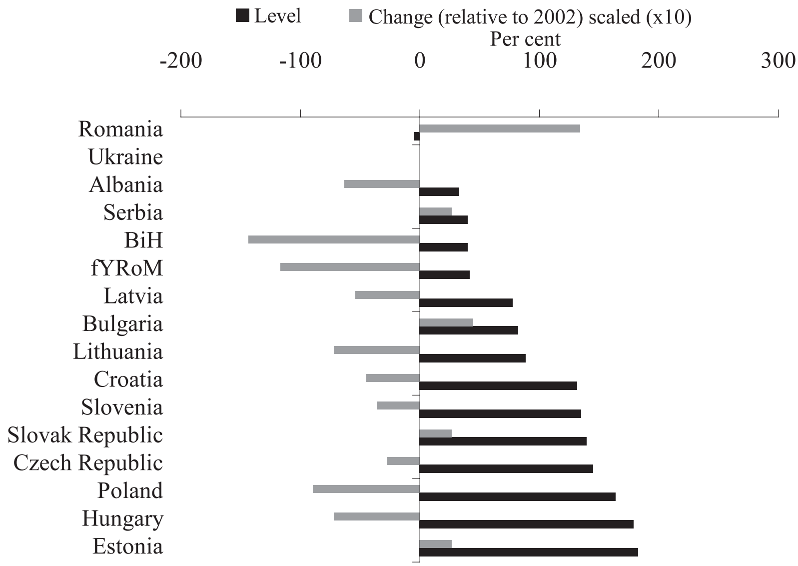
[15] See EBRD (2006). Including agriculture tends to even increase the overall estimate of informal sectors.

[16] See Bosnia's IMF Article 4 (2005).

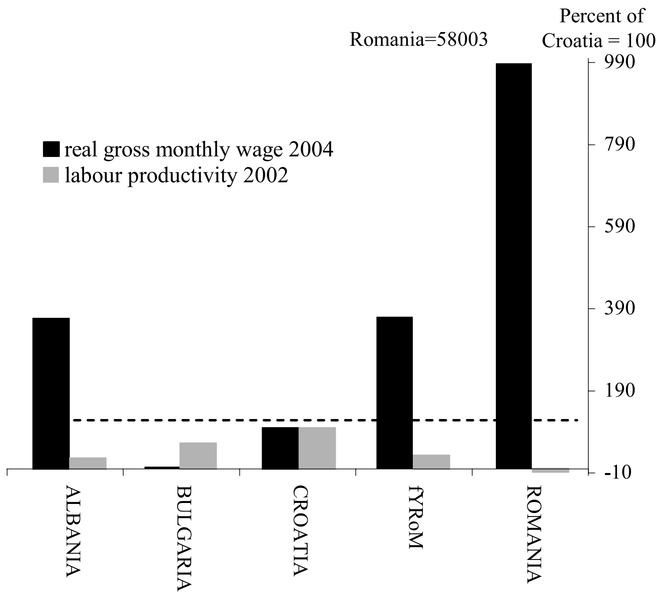
Moreover, fundamental restructuring and the introduction of best-practice corporate governance in the non-financial sector has been slow to proceed (Table 15), resulting in weak financial discipline and the risk of a further non-performing loans (NPLs) down the line. Meanwhile, scarce resources are being diverted away from potentially more productive, fast growing and profitable private enterprise. During 2006 however, some improvements were recorded in Romania (passing of corporate governance legislation) and the former Yugoslav Republic of Macedonia (approval of new bankruptcy legislation). A review of the impact of recent structural reforms in Romania is contained in Box 5.

Chart 14. Labour productivity (sales per worker) relative to the Ukraine (in ascending order)



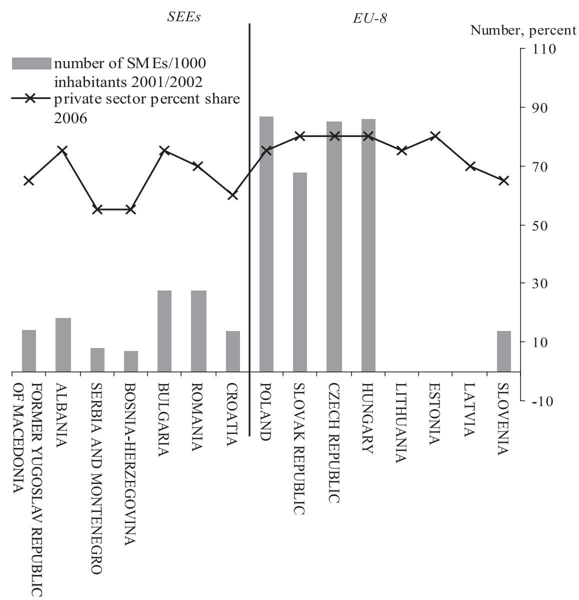
Source: EBRD Transition Report 2005

Chart 15. Labour productivity and real wage costs in South East Europe*



* Data for other countries in the region unavailable. Source: EBRD, UNDP and own calculations

Chart 16. Private sector share and SME density



Data unavailable for the three Baltic states. 2006 data indicate a private sector share of 65% for Montenegro and 55% for Serbia. Source: EBRD (2005) and (2004)

Table 15. **S.E. Europe: Scoring on EBRD transition indicator for enterprise reform and privatization, 2006**

	Large-scale Privatization	*Governance Enterprise Restructuring*
Albania	3	2+
BiH	3–	2
Bulgaria	4	3–
Croatia	3+	3
fYRoM	3+	2+
Romania	4–	3–
Serbia	3–	3–
Montenegro	3+	2

Source: EBRD

Indicators range from 1 to 4+. 4+ represents standards of industrialised market economies; 1 represents no change from centrally planning.

Box 5: Structural reform issues in Romania

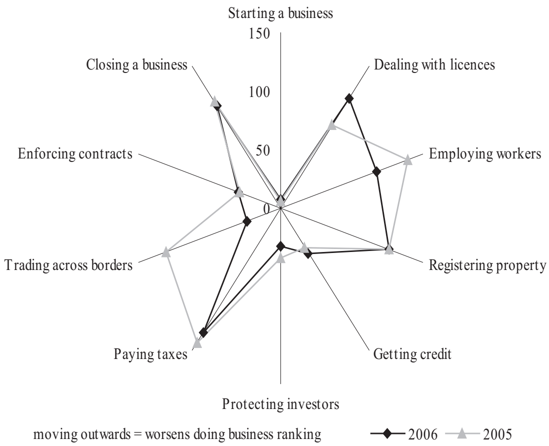
According to the World Bank Doing Business 2007 Report, Romania was among the top reformers in 2005/2006.[17] Out of 175 countries, it jumped from the 71st to the 45th place in a comparative ranking across countries. What does this actually mean? And what are the strength and weaknesses of Romania's business climate? The aim of this box is to provide an overview of Romania's structural reform issues. Most recent progress in improving the business climate in Romania was achieved in facilitating trade across borders and in the labour market (Chart A). On the former, Romania improved from the 121st to the 35th place. Trading has become more speedy and the number of documents needed to export and import have been drastically reduced. In the labour market, the labour code has been reformed, facilitating the hiring and firing of workers.

While only implicitly addressed in the doing business assessment, company level surveys designed and evaluated by the World Bank/EBRD in the Business Environment Enterprise Performance Survey (BEEPS) suggest that between 2002 and 2005 firms also perceived the scale of bribe and kickback taxes and their frequency to have markedly declined.[18] Interestingly, and easily forgotten in the 'lumping' of country characteristics, Romania already scores quite well in a few areas: 'starting a business' and the provision of infrastructure. On the former, Romania ranks 7th out of 175 countries. It takes for example only 11 days to set up a business, compared with 32 in the rest of the region and close to 17 in the OECD. This is particularly striking given

[17] See World Bank Doing Business 2007.

[18] For these and following references, see EBRD Transition Report 2005.

Chart A: Doing Business in Romania (0-175)



Source: World Bank

that corruption is considered to still be a major business problem. Regarding infrastructure, while there are still some issues regarding service delivery (e.g. delays in obtaining electrical connections), the actual quality of infrastructure appears satisfactorily. Increased competition in the telecommunications sector for example is improving quality and reducing prices.

Yet, despite these favourable aspects, the Romanian economy still faces important structural challenges. Despite recent reforms, the labour market continues to perform poorly. A reflection of this is that labour force participation has declined by over 5 pp from close to 62% ten years ago. In contrast to Poland and Slovakia, firms' perceptions of labour regulations in Romania have become more negative between 2002 and 2005. 16% of firms identify labour regulation as a major constraint. According to the IMF, the still obligatory nature of collective wage agreements for non-signatory parties represents a key constraint and should be urgently addressed. Further weaknesses represent dealing with licences, registering property, closing a business and the administration of taxes (Chart A).

While some economic indicators taken together are unambiguous in their message, there are others that are more ambiguous. These relate to access to finance and the protection of creditor rights. Regarding access to finance, while credit bureaus have relatively low coverage, the scope, access and quality of credit information is relatively good (Romania scores 5 out of 6). Moreover, according to the company surveys, while the value of collateral needed for a loans is less than in other countries in the region (142% instead of 154%), more loans actually require collateral (93% instead of 83%). Overall, about 20% of firms consider access to finance as a major constraint, compared with 15% in Europe and Central Asia and 26% in other Lower Middle Income Countries.

Regarding the protection of creditor rights the messages are also conflicting. In terms of transparency, the country scores relatively highly in the Doing Business Assessment (Disclosure Index 9 out of 10). The same holds for the Investor Protection Index (same score as OECD countries). According to the EBRD Legal Indicator Survey however Romania shows low compliance with international standards for corporate governance. Moreover, unlike in some of the central European economies, minority shareholders have no access to company books, nor can they call in an independent audit. A new bankruptcy code notwithstanding, the recovery rate on an insolvent firm is estimated at 19.9%, well below the OECD with 74%, but also a touch lower than other countries in the region (29.5%). This is despite a respectable outcome on enforcing contracts (it takes less time and costs less than in OECD countries, despite a greater number of procedures).

Overall, this suggests that the analysis of countries' business climate is complex and requires in depth analysis. In addition, simple indicators – if taken in isolation and out of context – could be abused to misrepresent a more nuanced picture of a fast evolving and hence hard to capture economy.

Business constraints are typically more serious than in Central Europe and the Baltic States, inhibiting private sector development, especially smaller firms. According to the 2005 EBRD/World Bank BEEPS, and despite recent reforms, more firms in our region complain about problems of doing business. Complaints range from insufficiencies in infrastructure (transportation, power and telecommunications) to burdensome regulations and red tape, and high corruption costs. Poor infrastructure is partly a legacy of recent wars; but even outside former Yugoslavia, networks and supplies are deficient and unreliable. There is only one bridge linking Bulgaria to Romania. Albania still faces frequent electricity shortages. In 2006, however, a good deal of progress was achieved in telecoms, largely through stronger competition in the mobile phone market. As a further illustration, Box 6 reviews these issues in Albania.

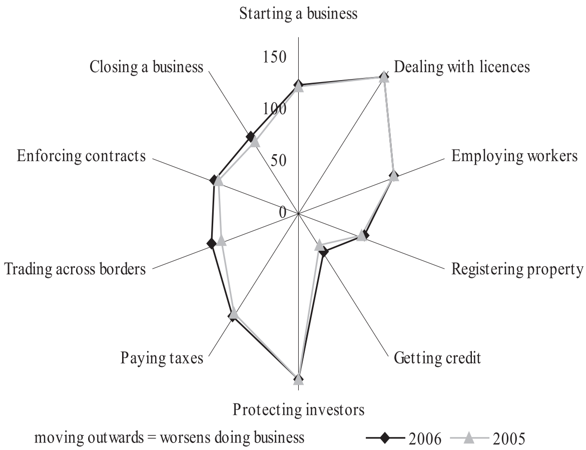
Box 6: Structural reform issues in Albania

In relative terms, Albania's business climate has worsened slightly in recent years. According to the Doing Business 2007 Assessment, Albania fell back from 115^{th} rank to 120^{th} rank out of 175 countries. The deterioration was across the board, and greatest for "trading across borders" (Chart A). The recent change is worrying in the context of already low structural performance. There appears to be consensus that corruption, taxation, infrastructure and the working of the judiciary represent key areas of concern.

Some 80% of firms in 2005 considered taxation to be a problem, against around 55% in South East Europe as a whole. Tax administration is also perceived more cumbersome. The significance of the informal economy – estimated at 33% of GNP – is therefore not surprising. Another constraint still in Albania represents the lack of adequate infrastructure and poor delivery. Over 60% of surveyed firms considered the provision of electricity to be problematic, compared with 20% in other parts of the region. The EBRD Infrastructure reform indicator suggests substantial problems in the provision of water. Another major issue is perceived to be corruption. Over 60% of firms indicate this as a problem and 45% of firms say they have to give gifts to obtain import licences. Conflict resolution and the working of the courts is also perceived to be a major issue. Only 20% of firms have used courts, against double that in South East Europe as a whole (Chart B).

That said, on these latter issues, conditions have been improving more recently. Bribes as percent of sales have plummeted in the three year period 2002–2005, and the reduction has been found to be statistically significant.[19] The Millennium Challenge Account finances measures to reduce corruption in tax administration and the recent introduction of a Large Tax Payer Office should improve transparency and encourage compliance. Organised and street crime have both declined markedly. But whether this represents an underlying improvement in political governance and law and order or just a reflection of a more prosperous macroeconomic environment remains to be seen.

Chart A: Doing Business Indicators Albania (0-175)



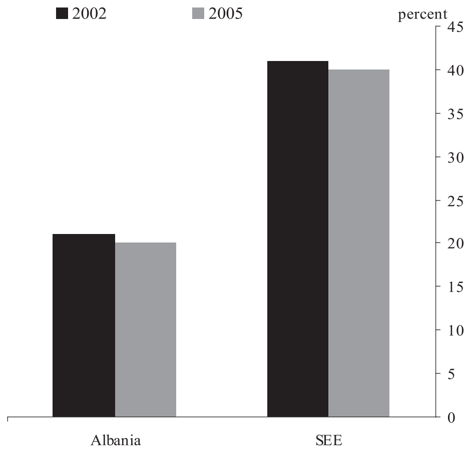
Source: World Bank

The least constraint for businesses appears lie in the financial sector (rank 48th out of 175 – see Chart A). Given the considerable reforms and overhaul of the system – as discussed in this paper – this does not come as a surprise. According to the BEEPs, loan negotiations have become less lengthy and more new investments are indeed being financed by formal borrowing. It is interesting that despite all the other more significant business constraints, access to finance is somewhat easier in Albania than

[19] See EBRD Transition Report 2005.

elsewhere in the region. Thus, also viewed from this angle, one might wonder to what extent the current credit expansion is sustainable and healthy.

Chart B: Per cent of firms that have been to court over the past three years



Source: World Bank/EBRD

Finally, it is interesting to flag again discrepancies in messages provided by different analyses. According to the Doing Business 2007 Assessment, Albania scores amongst the worst in investor protection- it ranks 162nd out of 175 (Chart A). Disclosure for examples is considered dismal. On the other hand, research by the EBRD suggests that compliance with international standards for corporate governance is not too bad (medium rated) for Albania – better than for example in Bosnia and Herzegovina or Romania.[20] Moreover, minority shareholders have considerable rights to access company information – something that is not the case in many other countries in the region and even in the CEEs.

Regulatory uncertainty is cited as another major obstacle to private sector activity. Examples of this range from delays and uncertainties about privatisation (e.g. Kosovo, Bosnia and Herzegovina) to the handling of war restitution claims (e.g. Bosnia and Herzegovina). Bribes and red tape represent a major constraint – 25% of firms in South East Europe say that bribes are frequent compared with slightly over 10% in the EU-8. [21] As a result of ongoing corruption problems, contract enforcement remains indeed a major difficulty for firms. In a global comparison, businesses in these economies (apart from Croatia) face higher enforcement costs than 25% out

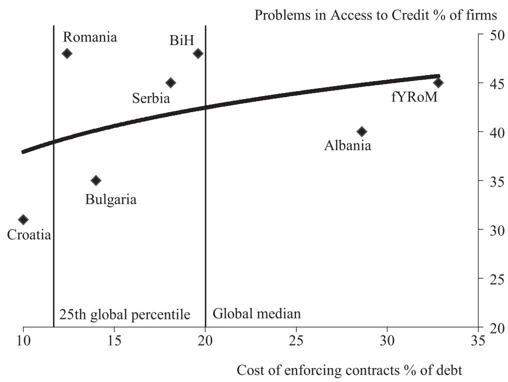
[20] Ibid

[21] Progress on corruption has been made, notably in tax and customs administration. See EBRD (2006)

of 155 countries surveyed. the former Yugoslav Republic of Macedonia and Albania score worse than 50% of such countries (Chart 17). About half of surveyed firms under the BEEPs consider the functioning of the judiciary as a problem in doing business, against only around 27% in the CEEs. These phenomena may have some political roots. In any case, weak enforcement seems to affect banks' willingness to lend. Empirically, there is a relation between the cost of enforcement and banks' loan to asset ratios (Chart 17 and Box 7).[22]

Among other factors constraining credit availability, unresolved property issues and lack of collateral are particularly important in the region. These factors again directly affect the ability of banks to lend, notably to small-sized firms with less of a track record and reliable company information. This is of course a problem in all countries that experienced forced population movements, such as the Former Yugoslav Republics.

Chart 17: Problems in access to credit and cost of debt enforcement



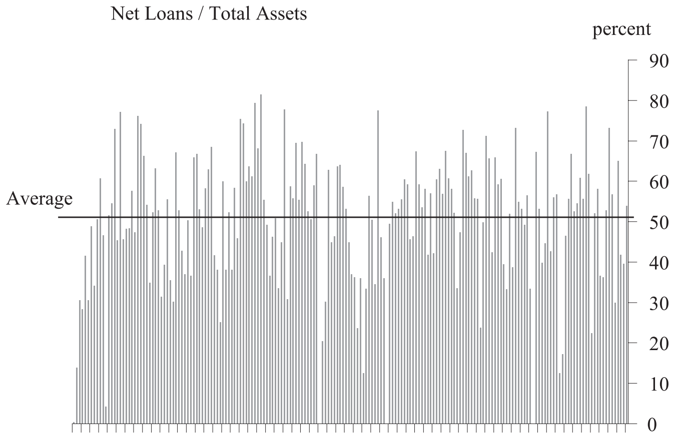
Source: EBRD BEEPS 2005 and World Bank Doing Business 2005

[22] It is worth noting that Hungary where SME lending is becoming increasingly widespread ranks 12th on the global enforcement scale, ahead of a number of Euro-area economies.

Box 7: Loan-to-asset ratios of banks in south-eastern Europe

While averaging around fifty percent, casual observation shows large discrepancies in loan to asset ratios across banks in South East Europe (Chart A). Loan to asset ratios show banks' propensity to engage in traditional financial intermediation towards the domestic private sector.[23] In that, akin to credit to GDP ratios at an economy-wide level, these data – for countries at an early stage of development – provide insights about financial deepening: to what extent it can be explained by fundamentals and is hence sustainable; whether it suggests potential for catch-up and what the fundamentals behind it are, for example macroeconomic or bank-specific.

Chart A: Net loan over asset ratios for 150 banks in south-eastern Europe



Source: Bankscope

To analyse this, a regression of pooled data of net loans over asset ratios of 150 individual banks from 2000–2004 in Albania, Bosnia and Herzegovina, Bulgaria, Romania, Croatia, Serbia and the former Yugoslav Republic of Macedonia was run on indicators of bank health such as the net interest margin, the level of capitalisation, loan-loss reserves and the bank's market share over the same time period. The effect of the latter on the propensity of banks to lend could be positive or negative, depending if economies of scale and hence lower interest rates or effects of diminished competition and hence higher interest rates dominate.

The choice of macroeconomic variables was inspired from past research on financial deepening[24]. The fiscal balance and a dummy for high inflation episodes should pick up respectively public sector crowding out (and resulting in banks lending less) and macroeconomic instability. GDP per capita was used to proxy for the availability of collateral and general economic development. Finally, the World Bank Doing Business cost of contract enforcement measure was included in the regression.

[23] Banks assets are typically composed of loans, securities, interbank deposits, cash, repos, trade or other short term credit, foreign assets and fixed assets.

[24] See Cottarelli, Dell'Ariccia, Vdadkova-Hollar (2003)

We find the following results:

- Given the amount of idiosyncratic factors that such a regression cannot pick up, the fit of the regression is relatively low, but is reasonable if we include only banks with market share of at least 2% (n=74) (R2 of 0.4) (Table A). This suggests that there are a number of small institutions with possible reporting issues; run by non-market considerations; and/or are very specialised niche operators.

- The larger the bank's market share, the smaller the loan to asset ratio, suggesting perhaps that economies of scale effects are outweighed by increased monopoly power.

- As expected, the higher the debt enforcement cost, the lower the propensity to lend. Also, high inflation and fiscal deficits discourage lending. As nearly all countries now pursue stability-oriented policies, sustainable further development of lending activities will need to be driven by bank-specific factors or improvements in the institutional environment.

- In-line with economic theory, the higher the interest margin, the more banks lend. Interest margins are driven by structural (reflecting lending technology, management) and cyclical conditions. Privatisation and FDI into banking sectors in 2005 and its effects since, which are not picked up in these estimations, are likely to raise profit margins and possibly imply a higher desired loan to asset ratio in the future.

- GDP per capita, the capitalisation of banks and loan loss reserves have no significant effect in the regressions. The latter is interesting; it might suggest that loan-loss reserves are inadequate and/or mis-specified.

- The residuals pattern is suggestive that loan-to-asset ratios are below equilibrium in Bosnia and Herzegovina and Romania, but above in Serbia and Croatia (Table B and Chart B).[25] Indeed private sector loan growth has indeed picked up in Bosnia and Herzegovina since 2004, but also in Croatia – and massively in Albania. Conversely, Bulgaria has seen a fast decline in private sector credit growth – plausibly driven by central bank tightening of administrative measures.

Table A: Regression results of pooled estimation of 62 banks' loan to asset ratios in South East Europe

Dependent Variable: Net loans over asset ratio
Method: Least Squares
Date: 07/06/06 Time: 14:47
Sample: 1 74
Included observations: 62

[25] If however all loan to asset ratios in 2000-4 are out of equilibrium, then the residual pattern we observed are biased.

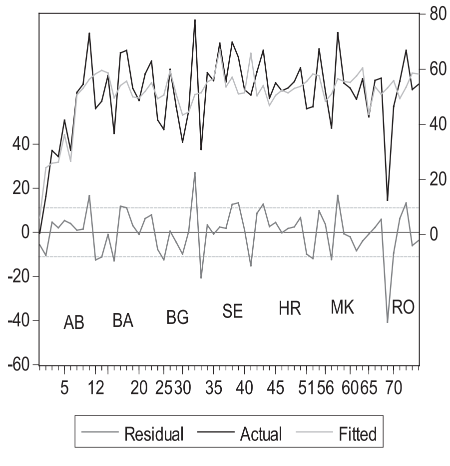
Variable	*Coefficient*	*Std. Error*	*t-Statistic*	*Prob.*
C	64.95964	5.544277	11.71652	0.0000
Net interest margin	1.299516	0.706223	1.840094	0.0713
Capital ratio	0.113463	0.178805	0.634566	0.5284
Fiscal deficit	2.806032	0.662777	4.233749	0.0001
Enforcement costs	–0.367810	0.226568	–1.623397	0.1103
High Inflation dummy	–8.242240	3.604610	–2.286583	0.0262
Market share	–0.402710	0.183784	–2.191219	0.0328
Loan-loss reserves	–0.091905	0.153880	–0.597251	0.5528

R-squared	0.490156	Mean dependent var	50.82613
Adjusted R-squared	0.424065	S.D. dependent var	14.61103
S.E. of regression	11.08837	Akaike info criterion	7.769585
Sum squared resid	6639.408	Schwarz criterion	8.044054
Log likelihood	–232.8571	F-statistic	7.416382
Durbin-Watson stat	1.991273	Prob(F-statistic)	0.000003

Table B: Average residuals for different countries

AB	BA	BG	SE	HR	MK	RO
-0.3	**-2.6**	**0.4**	**1.7**	**1.35**	**0.1**	**-2.8**

Chart B: Actual and fitted observations of loan to asset ratios in South East Europe



Official labour markets are relatively rigid – especially in the Western Balkans, but also in Romania. Research suggests that job creation and destruction rates are low compared with the EU-8, including compared to those expected at a similar stage of transition.[26] Except in the former Yugoslav Republic of Macedonia, where reforms have been introduced in 2005, and Kosovo which has no law, employment protection laws continue to be stringent, pushing up labour costs, preventing industrial and managerial change, while promoting informal enterprise.[27]

Finally, political issues are probably constraining private enterprise as well as intermediation (Box 8). For example political uncertainty and/or potential ethnic/community unrest increase business risk and hence the required rate of return, constraining private sector investment and hence effective intermediation. The same holds for local discrimination of minority ethnic groups and their limited access to resources and institutions. This applies mainly to the Western Balkans, though all countries are considered higher political risk than the EU-8.

Box 8: Politics in the Western Balkans and how they matter for the investment climate

Survey results and studies suggest that a large part of the region is still characterised by significant political weakness.[28] Political parties and elected governments are held in low esteem by the public at large in contrast to say non-elected institutions such as the church (in Serbia for example) or the European Commission (in Albania for example).

In addition, electoral cycles are relatively short and changes in power are typically accompanied by complete renewals of administrative bureaucracies. Political funding is considered opaque. In some countries political power is being increasingly devolved to local levels. Finally, the region continues to be influenced by a nationalistic mindset (as reflected by non-negligible support for radical parties), flaring tensions between different communities.

The channels through which political fragility affects the investment climate are numerous. The perceived limited legitimacy of current elected leaders and bureaucracies weakens their ability to enforce rules and regulations (Chart A). It also has the potential to encourage corruption as administrators know that their position is likely to be short-lived.

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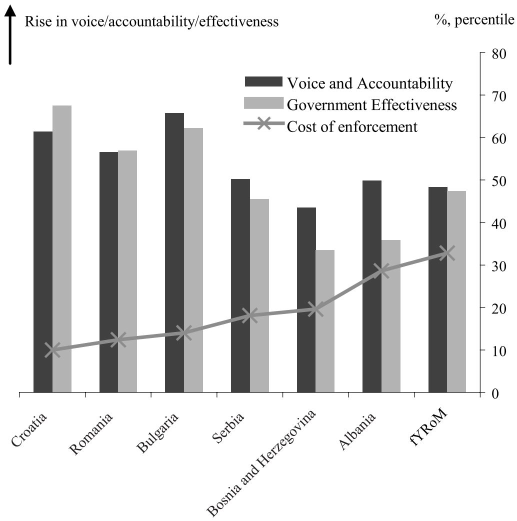
[26] See Slay, (2006).

[27] While Croatia scores better on most BEEPs than other SEEs, the World Bank Doing Business score –which is based on a more factual analysis of regulations and laws ranks Croatia at the bottom of the region, together with Albania. Bulgaria and Romania perform best, while the latter on a number of criteria does worse on the BEEPS.

[28] Also see 2005 World Bank Governance indicators.

The trend to decentralise power could also in some instances contribute to a greater incidence of bribe-taking and bending of rules: decision-making local officials often find it more difficult to resist pressure by local monopolies to abuse power than their peers in a more centralised and thus 'distant' political system. Finally, nationalistic ideas have the potential to trigger discriminatory treatments of local citizens, be it by government officials or private persons. As a consequence, access to resources and the market and hence the investment climate is significantly impaired for concerned firms and entrepreneurs.

Chart A: Voice and accountability, government effectiveness and cost of debt enforcement



Source: World Bank

In sum, while country data for investment climate indicators at times seem counterintuitive and hard to reconcile with other facts, the overall general pattern of failings matches well with concerns that have become apparent at the more macroeconomic level, notably the orientation of credit to perhaps less productive sectors, rather than to smaller sized firms. The ensuing microeconomic reform priorities need therefore also be placed into a broader financial stability context. In this regard, effective financial supervision is crucial.

Structural reform priorities

The lending environment in south-eastern Europe illustrates the scope for continuing reforms to raise the returns on productive ventures and help ensure balanced financial development. Issues of financial system efficiency, and ultimately stability, cannot be divorced from market processes in the real economy – including the effectiveness of judicial systems and insolvency procedures. Given limited implementation capacity, policymakers need to develop a sharply focused diagnosis in each case, but the broad lines of structural policy priorities can be inferred from the discussion above.

First, ***improvements to infrastructure and networks are key***, notably in the Western Balkans. The scale and quality of transport systems and the provision of power, water and telecommunications, all require major enhancement. Given budget constraints, governments need to think how better to involve the private sector in financing and managing infrastructure, while controlling contingent liabilities. A prerequisite is the creation of independent regulatory agencies as well as incentive-compatible tariff and pricing schemes for private operators. The efficiency of ports and customs requires review to lower transport costs and facilitate exporting activities by small firms – thus also reducing vulnerability to exchange rate shocks. Romania, for example, made progress on this front in 2005 by easing trading across borders (see Box 5).[29]

Labour market reforms are also a high priority. As discussed earlier, this would typically cover social contribution and income tax levels, and excessive labour protection. It could play a sizable role in reducing the informal sector. Efforts are required to bring long term unemployed back into the labour force, through retraining and potentially tax incentives, while cutting the duration of unemployment benefits and being stricter on abuse.

A further route to reduce frictions in the financial sector is to improve the working of the ***legal and judiciary environment***. Policy-makers need to take action to ensure not only that bankruptcy laws are adequate but that the legal process operates in an efficient manner – facilitating an orderly resolution of claims. Property rights need to be redefined and clarified to facilitate the use of land and housing as collateral. Judges require commercial training, and their numbers increased to speed up procedures and lower costs. To the extent feasible, out of court settlements could be facilitated. This is part and parcel of strengthening the benefits for firms to accept operating in the formal sector: the protection of property rights and low cost access to an even-handed judiciary is thus crucial.

[29] See World Bank Doing Business 2007.

But in addition to removing distortions, are ***more activist policies also*** needed? Possible justifications lie in the small size of firms and of markets; the lag in institutional reforms; and continuing political uncertainty in some cases. Examples of such policies include the setting up of development and microfinance banks (see Box 9). Codes of conduct to facilitate debtor-creditor relations are another possibility. Guarantee funds or subsidized credit lines for SMEs are also sometimes advocated.

Microfinance banks have developed rapidly, boosted by foreign donor and IFI support. Most of those in south-eastern Europe operate on market principles, comply with bank supervision, cover costs, and increasingly approach full sustainability, but still benefit from low cost long term IFI refinancing. Their integration into traditional financial sectors has progressed and hence their ability to channel local savings. But penetration rates are still low (less than 0.3% of population).[30] The challenges to improve access without sacrificing sustainability are considerable. These are capacity constraints in human resources, the ability to monitor clients as networks grow, and trade-offs between ‘mission drift’ (i.e. a tendency to grow the loan balance to the detriment of smaller borrowers) and profitability.[31]

Another angle of approach is to try to improve working relations between small firms and banks. Appropriate standards may need to be elaborated that meet the need of the creditor, while minimising the burden on firms. This requires a close collaboration between central banks and trade associations. The formulation of a code of conduct between banks and SMEs might raise awareness of mutual concerns and priorities, facilitating access for smaller firms. The government may also want to foster consultancy services for small firms to facilitate interaction with banks, provide market research, and strengthen their systems and skills, all with the aim to facilitate the creation and presentation of bankable projects. Credit registers (*centrales des risques*) may increase transparency in the lending market.

Box 9: The creation of the Micro Enterprise Bank of Kosovo and its early challenges

As Yugoslav banks fled the province during the Serbo-Albanian conflict in 1998/1999, the formal financial sector had ceased to exist. Given the volatile environment, small size of economy and low expected returns, no private commercial bank, neither local nor foreign, was willing to operate in Kosovo.

[30] See Gonzalez and Rosenberg (2006).

[31] See Cull et al (2005).

Asked by UNMIK to swiftly advance the establishment of a financial institution to improve access to financial services in Kosovo, IFC, EBRD, KfW and FMO joined forces. In autumn of 1999, the group selected the Frankfurt based consultant IPC (Internationale Projekt Consult) to help establish a fully-licensed bank with the aim to offer a range of financial services adapted to the demand of the target group, especially micro and small entrepreneurs.[32] In order to set incentives for the consultant, IPC was asked to take a minority 17% stake in the EUR 2.3 million equity of the institution. IPC invested via IMI (Internationale Micro Investitionen), a stockholding company it had founded for this purpose. In addition, the public development finance institutions looked for a private commercial bank as an investor and provider of relevant know-how in money transfer and cash management.

In December 1999 the Microenterprise Bank of Kosovo (MEB) was formed. Commerzbank, IMI and FMO invested directly into the equity of the bank. IFC and EBRD could not invest directly as Kosovo was not an officially recognized country. As KfW was using Financial Cooperation funds provided by the German government their challenge was similar. The solution was to fund MEB through warehousing arrangements via the Albanian FEFAD-foundation and the Micro Enterprise Bank of Bosnia which then bought equity shares in MEB, Kosovo, on behalf of IFC, EBRD and KfW.

"On 24 January 2000, the Micro Enterprise Bank of Kosovo was opened. Staff, management and owners were stunned by the volume of activity from the very first day and the pace with which it kept accelerating. Farmers in worn-out clothes, small traders and employees of NGOs queued to open accounts. Lending had to be delayed because of the overwhelming demand for deposits and money transfers. During February more than 2,000 money transfers were processed amounting to 100 million Deutschemark (EUR 50 million). Accounts were opened at a rate of 100 a day. The minimum deposit to open an account was EUR 12. Three quarters of the deposits were held in small personal accounts. Close to 25 % of the deposit accounts were owned by legal entities that had an incentive to minimize the use of cash for security and control reasons. These included UNMIK and many NGOs.

By June 2000, MEB had more than 8,000 clients. A second branch was opened outside Pristina in Prizren. Further branch openings were planned for Peja and Gjakova. The challenges then were:

(1) Given the immense demand for services from the start of operation of MEB, how could the bank attract the numbers of sufficiently qualified staff needed? Finding university graduates who could be trained was difficult as the government in Belgrade had closed universities in Kosovo in 1994 in order to disenfranchise Kosovars. Furthermore, there were no banking training facilities or courses available in Kosovo.

[32] The technical assistance was funded by the German government, the Netherlands, the US Treasury Department and the European Union.

(2) How would MEB manage to expand the branch network to other cities and to rural areas beyond Pristina when physical were hard to come by? Many buildings in central locations had smashed windows or gaping holes in their façade. The renovation was costly. Moreover, property titles were not verifiable.

(3) What contributions could the owners of MEB make to the reconciliation in a divided Kosovo? They were eager to contribute to whatever possible. One issue was to find staff willing to serve Serb clients in the region around Mitrovica.

(4) What would make cash handling manageable and safe? Almost all deposit account transactions involved physical exchange of cash. Guaranteeing that MEB always had sufficient cash was a huge challenge. The Deutsche Mark notes and coins had to be brought in from Germany while the airport in Pristina was closed. Cash transports by land were too risky given the security situation of Kosovo's neighbours.

(5) How could the volume of cash transactions be further increased without increasing the strain on MEB's systems? How might new technologies help?"

Source: KfW

Credit guarantee programmes (CGP) are at times advocated to facilitate small firms' access to capital.[33] These programmes jointly provide collateral and insurance, and exist in various configurations in developed and developing countries. In south-eastern Europe, most countries dispose of SME guarantee funds or other subsidises SME lending schemes. Criticism of traditional government credit schemes has pointed to their "second best" nature, and failure to address underlying distortions. If the lack of collateral represents the underlying problem then it is optimal to unlock collateral through say clarification of property rights.

In addition, CGPs risk creating new distortions. For example, given limited funds, guarantees could crowd out viable projects and SMEs. Moreover, it is not clear that CGPs become self-sustaining given the high administrative costs of servicing SMEs. Finally, government funds raise issues of political interference, corruption and accountability. But evidence on the quality and quantity of guarantee funds and subsidised SME schemes through development banks in south-eastern Europe is sparse. An in-depth examination would thus be welcome – notably in light of current significant credit misallocation risks.

[33] See. Green (2003).

In ***financial regulation and supervision, further challenges need to be addressed***. Thus far, a very sound basis has been laid to support the development of the financial sector. In most cases, a key priority now lies not in formal frameworks but in issues of implementation – particularly risk-based supervision, credit assessment and consolidated oversight. Better information is needed for banks and supervisors concerning the financial health of households and corporates. There are differing approaches to the implementation of Basle II, with a key factor being the approach to risk assessment taken by foreign banks.

Supervision of non-banks has lagged, but is receiving greater attention – including where administrative controls have diverted credit outside the banking system. Much remains to be done in the field of non-bank supervision, including in the field of disclosure and governance rules. In Bulgaria for example, self-standing leasing companies report statistical information to the central bank, but are not supervised. The oversight of financial markets also needs to be strengthened, with issues of transparency and governance (including minority rights) a high priority.

An important and controversial issue is the role of supervision in addressing rapid credit growth. At the micro level, the priority is clear: to ensure the capacity of banks to screen credit and manage the risks involved in new segments of the market, where track records are not available to help in assessing risk levels. The more difficult issue concerns possible action to moderate aggregate credit growth. The appropriate question is whether banks and supervisors are internalising systemic risk in their evaluation of credit and market risk – and how this might imply re-designing or re-calibrating supervisory tools. One route could be more onerous stress-tests (including of indirect foreign currency exposure). Another tool is anti-cyclical loan provisioning of the type applied in Portugal and Spain; but this may run into tax and accounting obstacles. A further approach lies in imposing or adjusting minimum loan-to-value or loan-to-income ratios, which may moderate exuberance in mortgage lending.

A related prudential challenge is co-operation with foreign supervisory authorities. From a stability perspective, one key issue is prevention. In particular, it is not clear how a meaningful cross-border dialogue is to be conducted with regard to systemic credit risk. For example, foreign subsidiaries may have large and growing exposures to the real estate, including via mortgages. But each bank may be globally well-diversified. (They may also have an option of converting to branch status.) What is the basis for supervisory concern about such local risk concentrations? Should home supervisors enter into a dialogue on this with local supervisors and their own banks?

The assessment of liquidity is complex also, in terms of prevention. Should short-term intra-group liabilities of foreign banks be regarded as akin to direct investment, or are they a source of funding vulnerability from a macrofinancial perspective? Here, the dominant position of a few foreign banks in Eastern Europe could pose contagion risks, as highlighted in some local Financial Stability Reports. “Common lender” issues are familiar from Asia, though the strategic engagement of EU banks, and the institutional setting, to some degree qualify these concerns.

Complementing these issues of prevention are well-known dilemmas concerning crisis resolution, and in particular burden-sharing. It is in some circumstances unclear which authorities would bear the costs in the event of a crisis, or how these costs would be shared among them. Arguably, it is very hard to sort out issues of prevention effectively if the incentives resulting from resolution costs are unclear.

These issues can – and should – be kept distinct from any argument to use supervision as a surrogate macroeconomic policy tool, to help cope with constraints on monetary policy and/or tensions surrounding fiscal policy. Such a role for supervision is open to well-recognised objections. While this might look tempting to macroeconomic policy-makers during a boom, the countervailing danger of pressure on supervisors to ease prudential requirements in a downturn – thus reducing incentives to resolve bank problems and undermining confidence – should need no underscoring.

Nonetheless, faced with limitations affecting monetary, fiscal and local supervisory instruments, policy-makers in south-eastern Europe have made considerable use of administrative controls over credit to the private sector, citing monetary reasons among others. Bulgaria imposed stricter standards on provisioning and loan classification, and the central bank also put in place ceilings on credit growth and deposit penalties if banks exceed them. The National Bank of Romania imposed limits on foreign currency lending to unhedged borrowers (at 300% of bank equity). The main restrictions have been applied in Bulgaria and Croatia, in the form of direct credit ceilings.

A major difficulty with such approaches is that they have limited purchase with an open capital account, especially where banks are foreign-owned and major investors include international firms. Cross-border flows to firms can free up domestic capacity for lending to households. BIS data on cross-border credit to non-banks illustrates how sharply this can rise in response to domestic credit conditions. There may also be scope for credit to flow through alternative non-bank channels (as with leasing companies in Croatia, for example). Credit may indeed be diverted to intermediaries that are less supervised, causing negative spillovers for growth and stability.

Empirically, experience with administrative controls has been mixed. As suggested by trends described earlier, the jury is still out regarding the effectiveness of such measures. They may mainly provide a brief respite during which other policies can take effect, but they do not appear viable for a medium-term dampening of credit growth. Over time, they may well lead to the diversion of credit to other routes – including direct cross-border lending and intermediation by less supervised domestic institutions. Policy practitioners in the region give some credence, however, to certain measures that are more-or-less market-based and prudential in intent: centrales des risques; limits on loan-to-income or loan-to-value ratios; and capital ratio charges for banks with high foreign currency loan exposure to unhedged borrowers. Such measures, which can be fully justified in prudential terms, may indeed have welcome macroeconomic spillover effects by avoiding distortions that swell credit growth.

As noted above, authorities across the region have therefore stepped up regulation of leasing companies and sought greater coordination with other authorities regarding cross-border flows, as tightened regulation encouraged circumvention and alternative credit supplies. This has been one factor encouraging co-ordination or mergers among supervisory agencies. In 2006, for example, Croatia merged the supervision of all non-bank intermediaries. There has been some tendency across Eastern Europe to unify authorities; but the key operational concern is that, under all institutional options, there is a major effort to overcome barriers to information flows and co-ordination, either across supervisory bodies or between them and central banks.

In conclusion, it must be recognized that there is a wide diversity of structural features in south-eastern Europe, and equally varying degrees of advance with institutional reforms. Among other things, this variety is reflected in the different Accession status of countries – with Bulgaria and Romania already members, and others still on the threshold of Stabilisation and Association Agreements. But, across this diversity, patterns are evident in the structural and institutional challenges facing the region.

Among the key priorities are the working of formal labour markets; the problems of remaining state-owned or supported institutions; frameworks for competition; the judicial system; and financial supervision. Addressing these institutional challenges effectively is essential to unlock high medium-term growth potential. Moreover, by helping to foster a balanced pattern of financial flows, this can contribute crucially to ensuring macrofinancial stability over the medium term. These reforms need therefore also be placed into a broader financial stability context and their contribution assessed in that connection also. This is the topic of the next chapter.

6. Safeguarding financial stability

Financial stability – the soundness of financial links in the economy and their resilience in the face of shocks – is a crucial priority if the expansion of banks and other intermediaries in south-eastern Europe is to support sustained growth. In order to avoid financial stress, policymakers need to identify the nature of evolving risks, and the ways in which these could interact. On this basis they need to agree what contribution different policy instruments can make to containing or insuring against such risks and the role of policy co-ordination if risk management is to be effective. In this region moreover, as noted in Chapter 2, policymakers need to factor in significant constraints on key policy instruments.

This chapter explores the financial stability risks that face policy-makers in south-eastern Europe, and discusses the nature of the challenges they pose. This lays a basis to consider, in Chapter 7, what trade-offs and complementarities exist across the range of macroeconomic, financial and structural polices as they support stable financial development and sustained growth.

The nature of financial risks in the region

A key challenge for policy-makers is to assess financial stability as a property, not of individual sectors or institutions at a single point in time, but of the economic system as it evolves and interacts over time. In south-eastern Europe, this leads one to focus on five facets of financial stability in particular:

- Does the financial position of the public sector remain a source of financial stability risks? An unbalanced macroeconomic policy mix could trigger destabilizing developments in the exchange rate or capital flows. In some cases, moreover, public debt remains high – and even where it is low, there may be significant contingent liabilities from incomplete real sector restructuring or outstanding legal claims.

- To what extent are banks exposed indirectly to market risks through clients? Viewed in isolation, banks may be well-hedged against exchange risk; but their clients can be increasingly mismatched, with risks to growth and ultimately to the banking system.

- Could sound microprudential developments nonetheless give rise over the medium term to macroprudential risks? Rapid credit growth for consumption and residential construction could lead to a wide swing in the external position, while failing to support productivity growth that would facilitate later real exchange rate adjustment. Credit growth could also jeopardise the maintenance of low inflation over the medium term, complicating the "exit strategy" from hard pegs to the euro.

- Is vulnerability to international capital markets greater than it seems? The expansion of credit is increasingly financed through intra-group borrowing by foreign banks, and has taken place in uniquely favourable liquidity and risk premium conditions. A rise in international risk premia, coupled with a shock to any of the small number of EU-15 banks that own the eastern European banking systems, might lead to a slowdown (or even a "sudden stop") in lending across the region.

- Could financial stress lead directly to a growth crisis, even without a market crisis? Some economies may be "hard-wired" against an exchange market or banking crisis by hard pegs and well-capitalised foreign-owned banks. But overlending, excessive leverage, misallocation and unwarranted real appreciation could emerge over time and unwind in a prolonged growth crisis. The case of stalled convergence in Portugal under the euro offers a case study of such processes at work (Box 10).

Box 10. The Credit and Fiscal Cycle in Portugal, 1998–2002

As interest rates in Portugal fell towards average euro area levels, and following financial reforms, credit to the private sector rose from 86 to 148 percent of GDP during 1998–2002. Monetary conditions corresponded to the overall situation of the euro area – so real interest rates were low relative to Portugal's cyclical position and low also relative to the potentially high risk-adjusted returns in the real economy. (These conditions, of course, parallel those in a converging currency board country). With rising income expectations, consumption smoothing was supported by improved access to domestic and external credit. There was a strong supply response in housing, and no serious asset price bubble. In this environment, procyclical fiscal policy added fuel to the domestic boom, and the public debt ratio rose from 53 to 59% in 2001–2 (reversing the progress made in the previous two years). With demand outstripping supply, the external current account deficit exceeded 8%. The Bank of Portugal pressed banks to reduce reliance on short-term external funding, and strengthen their capital, to avoid market vulnerability. When fiscal correction became unavoidable, in 2002, it coincided with export weakness. The public and private sectors checked the rise in their debt simultaneously, compressing demand.

The upshot was that growth stalled, and an adjustment began in the real sector – including among borrowers from the banking system – that is still working its way through. In its domestic and external impact, this is not an extreme case of a credit boom (for example, in terms of real appreciation or asset price increases). But it required action by supervisors to check banks' funding vulnerability. And the strikingly procyclical role of fiscal policy ultimately damaged the process of sustained real convergence. Moreover, the heavy allocation of credit towards households meant that expansion had not incorporated a strong impulse to strengthen competitiveness in the productive sector. Plausibly, a greater effort to improve the flexibility of the real sector of the economy might have created alternative opportunities for the use of foreign savings that would have facilitated subsequent external adjustment. This illustrates aspects of market and growth risks during convergence credit booms, in a situation where national monetary policy is not available, and also some of the policy responses relevant to containing such risks.

(For a discussion of experience in Portugal, see European Commission, 2004.)

Appraising financial stability thus involves analysing sector flows and balance sheets, and the linkages among sectors, as these evolve under the influence of policy regimes. This means going beyond approaches that view risks mainly through the windows of the banking system. It requires a "bird's eye view" of sectors, exploring risk exposures and linkages. This places public debt stress tests in an integrated framework with stress tests of banks; it views bank assets and liabilities as one aspect of a national balance sheet; and it explores how policies influence patterns of risk-taking across sectors.

In addition, an integrated approach needs to consider the allocation of savings between productive and non-productive uses, and how this may influence the path and adjustment capacity of the external current account, net foreign assets and real exchange rate over time. None of this is to deny, of course, that the financial sector always remains "special" in terms of liquidity and contagion risks, and will require heightened attention.

The analysis which follows therefore draws on the analytical tools mentioned in chapter 2, but it seeks to organize their use in a multi-sector framework, and to incorporate the considerations about resource allocation highlighted in the intervening chapters.

The public sector

The financial position of the public sector is the bedrock of financial stability, crucially determining the overall level of risk premia in the economy and the impact on markets of the policy mix. Flows and balance sheet developments in the public sector are a natural starting point in any sector-based analysis.

During early transition the financial position of the public sector, including its contingent liabilities, was in some cases a main source of macroeconomic risk. Chapter 3 discussed how fiscal consolidation, linked where necessary with debt restructuring, has addressed this. The cautionary points registered there need to be kept in mind: in certain countries (notably Albania, Bosnia and Herzegovina and Croatia) the fiscal balance needs to be improved further over the medium term in order to place the public finances on a sound footing in terms of debt sustainability. Public debt stress tests reinforce these conclusions. In addition, the risk was highlighted of mismeasuring underlying fiscal positions during strong credit and asset market booms, and hence of ending up with an inadvertently pro-cyclical fiscal policy.

In a financial stability context, these considerations relating to sound fiscal management remain fundamental, but three additional points deserve attention: the contribution of the fiscal stance to the policy mix; the interaction between saving-investment balances in the public and the private sector; and micro aspects of fiscal policy as these affect credit and asset markets. These factors can play a key role in containing macrofinancial risk.

As regard policy mix, a customary hazard during economic catching-up would be that too much burden of demand restraint falls on monetary policy. This turns out not to be the characteristic dilemma in this region. The predominance of fixed rate regimes means that monetary policy is to varying degrees exogenously set. In practice, cyclical developments in the euro area have meant that monetary conditions have remained fairly easy at a time when growth across south-eastern Europe has accelerated. More broadly, global financial market conditions have featured low real interest rates and risk premia. Monetary conditions in the euro area have recently been tightening, which will ease this dilemma.

So far, the burden of demand restraint has thus fallen very much on fiscal policy. Even in the floating rate cases the scope for monetary tightening has been to some degree circumscribed in this environment. Fiscal performance has varied across economies, but at a minimum policymakers have tried to avoid adding fiscal stimulus during this period of private sector expansion.

Over the past two years, public savings have been raised by more than 2 percent in Bulgaria, Croatia and Serbia, and by 1 to 2 percent in Bosnia and Herzegovina and Romania. The scope to further improve nominal budget balances during periods of strong expansion is a key challenge for the period ahead, as discussed earlier. But these developments mean that fiscal policy, the interaction between saving-investment balances in the public and the private sector has on the whole exercised a contractionary effect on external imbalances.

Concerning the influence of microeconomic aspects of fiscal policy on credit and asset markets, two elements deserve particular attention. The first is the tax deductibility of real-estate related borrowing. The second is debt management policies, which in the higher debt countries can help contain overall currency and rollover risks. These aspects of policy offer significant scope to contain macrofinancial risks by avoiding artificial incentives for mortgage borrowing and by reducing the potential vulnerability of the public sector – and thus the whole economy – to financial market shocks.

Firms and households

With changes in the public sector financial balance mainly being neutral to contractionary, the source of widening external imbalances has typically lain in the non-financial private sector – either directly through inward investment flows or indirectly as banks' net foreign positions have become more negative to finance credit expansion in excess of deposit growth.

Available data do not allow a full assessment of financial flows and balance sheet positions among firms and households. But some indication of non-financial private sector balance can be derived by adjusting external deficits for the contribution of the public sector deficit. This is a rough and ready approach, but yields some insights into the way fiscal authorities have reduced or increased pressure on resources as firms and households experienced emerging or wider investment-saving gaps (Table 16).

A striking feature is the scale of widening in the private sector saving-investment balance in certain economies. Bosnia and Herzegovina as well as Bulgaria experienced negative shifts on the order of 10 percentage points of GDP. Other economies, with the exception of the former Yugoslav

Republic of Macedonia, underwent shifts of some 6 to 7 percentage points. Private investment has been rising risen as a share of GDP (in a majority of cases) during the sustained growth of the past few years. In addition, private savings have declined quite significantly in some cases (recently, for example, Bosnia and Herzegovina as well as Romania), and this has in part reflected the relaxation of credit constraints on households. The monetary counterpart of these savings flows has been a pace of credit growth that tended to exceed increases in money demand, and this is why net external positions of banking systems typically have been shifting in a negative direction.

Table 17. S.E. Europe: External current accounts, fiscal deficits, private sector balances: 2000, 2005 (in percent of GDP)

	External current account balance		**Fiscal balance**		**Private Sector Balance**	
	2000	2005	2000	2005	2000	2005
Albania	–3.6	–6.9	–9.2	–4.7	+5.6	–2.2
BiH	–17.5	–26.6	–3.1	0.0	–14.4	–26.6
Bulgaria	–5.6	–11.8	–1.0	+2.3	–4.6	–14.1
Croatia	–2.6	–6.3	–6.5	–4.2	+3.9	–2.1
fYRoM	–1.9	–1.3	+2.5	–1.5	–4.4	+0.2
Romania	–3.7	–8.7	–3.8	–0.8	+0.2	–7.9
Serbia & Montenegro	–3.9	–10.0	–0.9	+0.2	–3.0	–10.2

Source: IMF, European Commission

The question arises how far domestic borrowing by firms and households has been rising at a pace that could threaten financial stability – e.g., because of pressure on external current accounts, prudential risks from poor credit screening or balance sheet vulnerabilities. A number of recent studies have explored whether credit growth or credit stocks have exceeded an “equilibrium level” based, for example, on prior experience in other emerging market economies. A related question explored in some studies is the related increase in net foreign liabilities of banking systems, which again should be seen as essentially driven by imbalances in the non-financial private sector.

These studies frequently cover all the eastern EU Member States, but only a few countries in south-eastern Europe (usually including Bulgaria, Croatia and Romania). A typical conclusion is that credit (especially to households) was “repressed” in the past, or cut back by hyperinflation, and is now on a path of catch-up following macroeconomic stabilization and bank reforms. Rapid credit growth is to be expected, although even in this framework the recent pace of growth in some cases prompts notes of caution.

A few economies in Eastern Europe are identified as possibly entering “at risk” in more than one study, and these usually include some cases in south-eastern Europe. For example, Egert et al. (2006) suggest that Estonia, Croatia, Latvia and possibly Bulgaria are cases where continuing rapid credit growth could be moving beyond “equilibrium” levels. They do not cite Romania in this connection because of the still low absolute level of credit relative to national income. Boissay et al. (2005) note Bulgaria and Latvia as cases of very high credit growth, relative to a broad range of countries, and to a lesser extent Lithuania, Estonia, Hungary and Croatia. In a second assessment using only data on CCEC economies, they identify Bulgaria and Latvia as very high credit growth cases, while also noting Estonia and Lithuania. In this assessment, they find an association between fixed exchange rate regimes and rapid growth in foreign currency credit. But they also highlight the very rapid growth of domestic currency credit in Romania.

Such analyses are informative, but they frequently do not capture the economic context in which the underlying borrowing by firms and households is taking place. For example, they do not take account of the composition of credit, or the overall saving-investment environment.

In this respect, one possible source of stress at the macrofinancial level could lie in high rates of growth in credit to households, as opposed to firms. Credit composition gives some clues that households account for a good deal of negative saving-investment shifts overall, suggesting that residential investment has been quite a significant contributor to wider external deficits in some cases. Mihaljek (2005) considers credit composition, and notes that experience has varied considerably with the sectoral pattern of lending. As the public sector share of credit has diminished (for example in Bulgaria, Croatia, and Romania), there have been differences in the counterbalancing rise in private credit. In Bulgaria and Romania, the share of credit to corporations has risen, whereas in Croatia it has declined as credit to households has expanded particularly strongly. Mihaljek also finds indeed a high negative correlation between the growth of household and corporate credit.

Some would view rapid credit expansion to households, relative to firms, has been seen by some as a catch-up phenomenon after years in which consumer credit was strongly repressed, and as likely to taper off over the medium term. Moreover, as noted earlier, data on the composition of domestic bank credit typically understate the flow of financial resources to corporations, since these typically benefit from the lion’s share of cross-border flows. This modifies the picture significantly in cases such as Bulgaria and Croatia.

Indeed, the analysis should be extended to cover all flows, including foreign direct investment.

Nonetheless, the question may deserve more attention. Some recent papers (such as Haselmann and Wachtel (2006) and Kraft, (2005)) have suggested that credit to firms in parts of Europe is being inhibited by poor business conditions. These factors are ultimately relevant to the sustainability of credit growth, whether it is financed internally or externally. Moreover, if productivity growth were slow as a result of this pattern of allocation, any needed real depreciation in the future would have to rely heavily on slow wage growth, where nominal exchange rate flexibility is limited. To that extent, the scope to enhance lending environments identified in Chapter 5 could be very important for financial stability as well as to growth.

Balance sheet analysis is also an important tool in assessing vulnerabilities. It can be inferred from credit and national income data that leverage in the household and corporate sectors is still relatively low, though rising. A specific concern, however, is the sizable proportion of credit flows and stocks denominated in foreign currency, including in the case of households. Data are not available to indicate where credit is hedged. In the case of households, most borrowings probably are not hedged, although some households receive remittances or hold foreign currency assets. To the extent this pattern persists over the medium term, it could give rise to quite wide-scale balance sheet vulnerabilities among firms and households.

The financial sector

The resilience of the financial sector is inherently difficult to evaluate in the absence of confidential supervisory information. The profile that emerges, taken together with the foreign ownership data presented earlier, suggests a varied picture across the financial sector. Nonetheless, certain patterns recur across these countries despite their dissimilarities and differing stages of advance with reform.

IMF/IBRD Financial System Stability Assessments (FSSAs) have helped stimulated the analysis of financial stability across eastern Europe. They have catalysed the use of techniques such as stress-testing, and have identified key priorities in the implementation of international standards and codes, as these relate to the financial sector. A number of recurring issues emerge across the region, when available FSSAs are read in conjunction with published IMF Article IV papers, and against the background of experience elsewhere in eastern Europe. While progress varies greatly case-by-case, key challenges correspond to those found in many emerging market economies:

- Banks' non-performing loans have been declining to reasonable levels, albeit in the context of sustained economic growth. Capital levels are well above Basle requirements, but they need to be watched as rapid loan growth continues. The response of small local banks to intense competition may be a point to monitor.

- Financial systems are very bank-based. While growth in non-bank intermediation may sometimes viewed as a complication of efforts to dampen credit growth, the medium-term consequence of more institutional diversification should be to increase the resilience of financial systems, provided supervision is effective.

- A major concern lies in credit risks related to unhedged foreign currency lending. There is a growing consensus that resulting balance sheet exposures represent a potential concern. Where these are in households, it can be argued that the risk is, in the first instance, to economic growth – since depreciation may be sharply contractionary in the presence of balance sheet risks. But ultimately, the banking system can be affected by slow growth or output declines. And, while the extent of exposures among firms is not known, a continuing increase might pose fragility risks.

Unhedged borrowing brings together micro and macro issues, since it is a micro distortion that is evidenced on a systemic scale, and which tends to accelerate credit growth to the extent risks are poorly priced and assessed. It also underscores that the health of the financial system cannot be assessed independently of the underlying strengths and vulnerabilities of it domestic clientele. Potentially, vulnerabilities could also arise in banks; to the extent matching rules have been eased in some euro hard peg countries.

Recent research on financial stability indicators has also highlighted the importance of deviations from trend in credit, asset prices and the real exchange rate, which can be valuable indicators that an excessive decline in risk premia is at risk of generating a boom-bust cycle (Borio and Lowe (2000)). Extracting trend estimates in such variables is difficult in a convergence setting. Nonetheless, attempts have been made to apply in eastern European techniques that identify a coincidence of rapid credit growth with deviations from trend in either real exchange rates or asset prices.

Building on the Borio and Lowe methodology, some results for south-eastern Europe are reported by in EBRD (2005), based on research work by R. Fox of Fitch Ratings and P. Nagy, also of Fitch Ratings and subsequently the EBRD. Countries were categorized as good, intermediate or weak in terms of “macrofinancial” factor, and also assessed on the standalone strength of their banking systems. The former Yugoslav Republic of Macedonia was rated low on macroprudential concerns, but with weak banks. Albania, Bosnia and Herzegovina, Bulgaria, Croatia and Serbia were rated as having intermediate levels of macroprudential risk, and again weak banks and. No countries were rated as being weak in macroprudential terms, since there was not a strong coincidence of credit growth with asset price/exchange rate concerns. But the authors noted that even intermediate levels of macroprudential risks can be serious when combined with very weak banks: in that respect, the banking system in Serbia was seen as very high risk, while Albania and Bosnia and Herzegovina were borderline.

From these assessments, a fairly clear picture emerges of the financial sector in the region. Individual banks are in a majority of cases foreign-owned, and the standard of credit management at the microeconomic level is considered to be strong. However, when entire banking systems are considered in a macroprudential context, several trends raise serious questions about the medium-term dynamics at work: the combination of rapid loan growth, unhedged borrowing, and narrowly bank-based systems is a serious watchpoint for the future. Ultimately the health of individual banks cannot be abstracted from the broader economic context in which they operate. How this evolves will depend crucially on the extent to which domestic and external savings are being channelled to productive uses, thus assuring a reasonably soft landing – in terms of external adjustment and economic growth – when current lending booms come to an end.

The external sector

Reflecting these domestic developments, external current account deficits have widened in some cases very sharply. And to the extent credit dynamics are based in the future on growing net external liabilities this trend may persist and broaden. This trend is a feature of many east European economies, especially those where exchange rate pegs have embedded monetary and fiscal stability, while also perhaps dampening perceptions of exchange rate risk.

The counterparts to these external current account deficits were already touched on above, and present a mixed picture. Broadly, the public sectors in

Albania and Croatia seem to be drawing rather heavily on external savings, which might give rise to some crowing out. To cut the cake another way, the sizable rise in investment in Bulgaria appears prima facie more reassuring than the decline in savings in Bosnia and Herzegovina, when one considers the source of pressures on current accounts – although more detailed data on the composition of investment in Bulgaria would be needed to confirm such an assessment.

Another way of looking at the external sector position from a stability standpoint lies in the traditional early warning systems based on foreign exchange market pressure indicators. EWS such models features often include changes in the ratio of reserves to broad money, money multipliers, and real interest rates. They thus overlap to some degree with approaches discussed above.

Foreign exchange EWS models are notable for their parsimony, relative accuracy, and established value as surveillance instruments. The IMF uses two such models as an adjunct to its surveillance activities (IMF, 2002). These are the Developing Countries Studies Division (DCSD) model and the Kaminsky, Lizondo and Reinhart (KLR) Crisis Signals model. Both aim at forecasting vulnerability to a foreign exchange crisis (a sizeable depreciation or loss of reserves) over a 24 month period – a longer time frame than used in typical investment banking models, and one that would facilitate pre-emptive policy adjustments. The parsimony of the models can be striking (Box 11).

Box 11. IMF Early Warning Systems

DCSD Model		**KLR Model**
Real exchange rate		Real exchange rate
Current account	*common*	Current account
Reserve losses	*features*	Reserve losses
Export growth		Export growth
Reserves/s-t debt		Reserves/M2
		Δ reserves/M2
		Domestic credit
		Δ money multiplier
		Real interest rate
		Excess M1*

* Defined as actual M1 less an estimated demand for money

A recent evaluation of these models confirmed that they are significant predictors of actual crises, but still generate a number of false alarms and missed crises. Based on out-of-sample predictions using 1999 data, DCSD performed particularly well: all countries showing a >50 percent probability of a crisis actually experienced one, while no crisis occurred in a country showing a probability of less than 26 percent. More recently, DCSD predicted the Turkey crisis but it performed poorly for Argentina.[34]

These models typically have a strong emphasis on external competitiveness, and this indicator yields fairly reassuring readings for a majority of economies in the region (Table 17). Recent competitiveness developments in Romania are, however, somewhat troubling: they highlight the tensions for monetary policy in the context of strong credit growth. In a deeper sense, of course, the competitiveness issues in the region have more to do with industrial and export structure, with economies that are quite dependent on products such as textiles seeming potentially quite vulnerable to imports from outside Europe.

Table 17. **S.E. Europe: Selected EWS data, 2005 (in percent)**

	Current Account/ GDP	**FDI/ Current account**	**Guidotti Ratio**	**R.E.E.R. (3-year change)**	**Export growth**	**Real Credit growth**
Albania	–6.9	61	19.3	5	+27.0	70.6
BiH	–26.6	34	22.3	–5	+26.2	27.6
Bulgaria	–11.8	72	32.5	7	+18.7	27.6
Croatia	–6.3	60	30.3	3	+7.7	14.3
FYROM	–1.5	46	23.2	2	–4.3	20.0
Romania	–8.7	88	48.4	7	+17.0	44.7
Serbia & Montenegro	–9.6	75	31.7	2	+30.4	41.0

Source: IMF and National Publications

To assess overall external vulnerability means assembling information about the evolution of public sector and non-financial private balance sheets with those of banks, against the background of the overall macroeconomic setting. This methodology is adopted in a study of Capital Flows to Central and Eastern Europe by Lane and Milesi-Ferretti (2006), which includes in its coverage Bulgaria, Croatia and Romania. They conclude that there are many favourable

[34] For a brief outline of these models and a discussion of their performance, see IMF (March 2002).

features in current developments, which illustrate how financial integration can potentially help accelerate real convergence. On the other hand, they note that the stock of external liabilities across eastern Europe, is high by international standards, and that the needed adjustment in trade balances is substantial, and not made easier by limited room for exchange rate correction. A sharp adjustment, for example against a background of tightening global financial conditions, could be “quite disruptive”. The authors underscore the case for policy steps to ensure the external resilience of these economies

Closely related to the preoccupations of Lane and Milesi-Ferretti is the need to assess contagion risks. Here the “common lender” characteristics in the region are striking. However, other features of economic performance provide important comfort in terms of issues identified in the contagion literature – including high transparency, strong reforms, and the strategic dimension of EU trade and investment integration. But official financial stability reports in the central European economies have for some time been flagging the potential medium- to long-term risks of a “sudden stop” in capital inflows.

The composite picture

An overall assessment of financial stability must assemble these sectoral developments into a comprehensive picture. And indeed, while country circumstances and challenges vary importantly across the region, a number of features recur sufficiently frequently to suggest a financial stability profile of economies in south-eastern Europe.

Typically the public sector has been addressing deficit and debt challenges, and these have ceased or should soon cease to be a prime source of instability. In some cases, such as Bulgaria, there is now a fiscal surplus. In Croatia, by contrast, there are still “twin deficit” issues and a high debt ratio; but fiscal consolidation has been moving in the right direction. In Serbia, soft budget constraints and potential fiscal liabilities from enterprise restructuring have yet to be fully addressed. In a majority of cases the challenge ahead is how far the public sector can take pressure off resources in the presence of private sector booms and (to differing degrees) constrained monetary policies.

The non-financial sector, in almost all cases, has been swinging more deeply into deficit, and leverage is rising from typically low starting levels. One concern throughout the region is the scale of apparently unhedged foreign currency borrowing, and thus the build-up of balance sheet risks. But a further very important medium-term question is whether foreign and domestic savings are being sufficiently allocated to productive uses that will foster higher productivity growth – thus underpinning real income increases, and helping to assure both competitiveness and future adjustment capacity.

In most cases export growth is quite encouraging, and more financing is flowing to firms than appears from domestic credit data. But the jury is out on the extent to which strong private consumption and housing investment could drive the external current account into deep deficit and lead to a potentially vulnerable cycle in net foreign assets and the real exchange rate. If productivity growth is not strong (as it has been in Romania over the past five years, for example) then external adjustment down the line could prove difficult, especially in the presence of fixed exchange rates or balance sheet risks.

On the financing side, economies in the region have benefited from a period of unusually low risk premia. In the future markets could look more critically at the level of external deficits in particular, perhaps discriminating more in terms of competitiveness and the sectoral use of savings. Meanwhile, the dominant role in the financial sector of a small number of "common lenders" from the EU-15 highlights the potential for contagion risks.

The challenge for policy

The fiscal policies and financial sector reforms advocated in earlier chapters should help to contain risks to financial stability in south-eastern Europe. Nonetheless, there is some degree of mismatch, across the region, between policy instruments and stability goals. Policy-makers report difficult challenges of both policy design and implementation in addressing rapid credit growth and wide external imbalances – trends that could give rise to financial stress of various forms over the medium term. The essence of the policy dilemma lies in the interaction of four constraints:

- With open capital accounts, significant foreign currency borrowing, and in many cases pegged exchange rates, there is at best limited scope to use monetary policy to restrain domestic demand. Strong cyclical developments (as opposed to high trend growth) will tend to be dampened through an appreciation of the real exchange rate, which over time will slow activity.

- Fiscal policy is in many cases already strong, and there are questions how far further feasible tightening will have an impact on domestic demand in these small and quite open economies.

- Foreign banks are not capital or liquidity constrained, and in a setting of low risk premia their involvement has accelerated financial expansion. Moreover, to the extent they are globally diversified, they can may be able to put on highly concentrated sector exposures (e.g., to real estate) in host country economies.

- Administrative measures to contain credit do not appear to be very effective in this environment of open capital accounts and institutional diversification, and in particular they may just end up discriminating against domestically based banks and/or diverting credit to less supervised intermediaries.

The implication is that sound macroeconomic and financial policies are very important indeed, but they may have only relatively modest traction over aggregate credit growth. Even where microeconomic quality control over loans is good, there is no instrument to contain very strong lending booms that could lead to an extended cycle in the external current account, net foreign assets and real exchange rate.

Whether this cycle leads to strong and sustainable catching up – the Ireland scenario – or ends in a serious setback to growth – the Portugal scenario – will depend crucially on the structural and institutional features of the economy, and whether these cause credit to be channelled to productive or unproductive uses. Thus, policies favouring the efficient allocation of financial resources end up also being critically important also for medium- to long-term financial stability. This suggests that the scope for policy complementarities is very high over the medium term, even if policy-makers face tough short-run trade-offs.

7. Key priorities and policy trade-offs

The previous chapters highlighted specific challenges in fostering financial development and stability in south-eastern Europe, and suggested policy priorities that – adapted to country circumstances on a case-by-case basis – can help to address these challenges. It remains to place these policy priorities in a single perspective, and evaluate the overall balance of risks in the region if action is not taken along these lines to help ensure sustainable financial development. Moreover, policy-makers in all countries have limited political capital and implementation capacity. This means that is important to explore the trade-offs and complementarities among different policy actions, in order to maximise the chances that the financial sector will indeed 'deliver' in each case in terms of sustained real convergence.

The challenges and key policy priorities

The upside possibilities for economic and financial development in south eastern Europe are clear. They represent a historic opportunity for these economies – even if the process of EU enlargement should move ahead somewhat more slowly than planned. This opportunity lies in the scope for accelerated trade and investment integration with the EU, and more broadly with global markets. And in this perspective, the strong financial sector dynamics at work in the region carry the potential to foster accelerated real convergence.

The countervailing concern, today, is that this strong financial expansion might end up delivering too little productive investment; too much unhedged borrowing in foreign currencies; and too strong a real appreciation, which then proves hard to reverse. In institutional terms, it is that foreign banks and corner-solution monetary regimes might shield economies initially from market shocks, but eventually expose them to a sudden stop of capital flows, amid balance sheet constraints that impede the use of the exchange rate to reorient economic activity. The economies with less flexible exchange regimes are perhaps particularly at risk of long-drawn out adjustment dilemmas. For inflation targeters, the same issues could pose acute market risks.

Such a scenario could develop in part because of troubling incentive problems. An environment of financing ease and well-buffered institutions could lull policy-makers to avoid tough choices, allowing long-run stresses gradually to build up. Specifically, monetary authorities may feel their hands to be tied; fiscal authorities may enjoy favourable revenue surprises during extended booms; and supervisors may see little choice but to rely on home authorities that are uninterested in local systemic risks and face unclear incentives with regard to liquidity support and burden-sharing risks.

This is where international surveillance can make a decisive difference. Strong traditions of IMF involvement, coupled with an expanding EU policy dialogue, and the role of the EU *acquis* could help highlight risks and pinpoint policy options. Close regional co-operation and exchanges of experience can contribute greatly, including through outreach to share the experience of adjustment fore-runners among the EU's eastern members.

The basic priorities are clear. They are, first and foremost, to improve market structures and frameworks, and institutional depth, in the real economy, thus opening up high risk-adjusted returns in productive activity. Only good productivity growth can validate rising income expectations, ease adjustment tensions, and ensure the international liabilities are serviced without domestic strains. It is infinitely more effective to strengthen market incentives, thus harnessing the capital flow tide productively, rather than construct administrative sea-walls that may only distort its impact.

However, given the current institutional weaknesses in these economies, some more activist policies may at times prove unavoidable. It needs to be borne in mind that these may come at a cost. There needs to be a searching examination whether they truly fill market gaps, or whether they risk distorting the allocation of resources? This is relevant in relation to administrative controls over credit, but it also applies to schemes to jump-start financing for small enterprises. Meanwhile, local supervisors urgently need to ensure that banks internalise systemic risks in the host economy, in both their funding and their lending strategies; and they will require full-bodied support from banks' home supervisors in so doing.

Alongside effective structural measures, macroeconomic policies must provide a bedrock of stability for the economy. More than in the past, policy-makers will need to be attentive to the risk-characteristics of policy regimes, and their interaction with financial markets. Well-designed fiscal reforms and institutions will be key in moderating pressures on the economy and unlocking supply-side opportunities; but the fiscal stance also needs to be prudently evaluated for the transient impact of strong financial booms. Monetary authorities, meanwhile, either need to embrace flexible strategies that allow true variability, and trigger sharp adjustments where needed in the short run. Or, where pegs are retained, they need to make clear the need for exemplary fiscal and structural polices over a long period – including because the timing of euro exits may depend on price developments that they cannot entirely influence.

Trade-offs and complementarities in policy reform

In pursuing reform priorities over the medium term, policy-makers inevitably will face complex trade-offs and complementarities, even in the case where reforms are well-advanced. It may be helpful in conclusion to explore what light is shed on these by the assessment in this paper.

The most fundamental question in this connection is whether policy-makers face ***trade-offs or complementarities between financial expansion and financial stability***. Should one imagine the relation between these as an inverted U, in which countries are best placed for sustained real convergence if they experience intermediate credit growth and current account deficits? Is very rapid financial expansion to be contained at all costs? That may be the implicit image in the mind of macroeconomists as they worry about high headline numbers for bank lending and private sector imbalances. It would be a very troubling conclusion in south-eastern Europe, where macroeconomic and financial policies, it appears, have limited traction over aggregate credit growth.

Here, the assessment in this paper points strongly towards complementarities between financial expansion and financial stability, but subject to actions that will strengthen the structural setting and institutional framework for private sector development. For the range of values observed in eastern Europe, there is no intrinsic reason to fear rapid financial growth – and the capacity to unlock this is indeed a major plus of the EU Accession process. But these gains are far from automatic. Strong increases in cross-border flows and domestic credit raise the stakes for policy makers, since they amplify both the favourable aspects of business environments and the distortions.

This sheds light on a second set of trade-offs and complementarities, which concerns the question whether, or when, country authorities should tighten the ***stance of monetary and fiscal policies in the face of widening private imbalances, appreciating real exchange rates, strong credit growth, or asset price increases:***

- A first priority in this connection is to conduct a continuing analysis of credit, asset price, competitiveness, and external current account trends that places financial developments in their real sector context, factoring in the overall resilience of linkages in the economic system.

- At any point, such analysis may reveal that serious distortions in credit allocation, or severe balance sheet stresses, are building up in the economy – or that the limits of external financing sustainability or adjustment capacity are being approached. The authorities may then conclude that, if these trends continue, the risks of a financial market crisis or a serious "growth crisis" will become overwhelming.

- Under such circumstances, it may be desirable to cut short the financial boom through a tightening of the macroeconomic policy stance, even at the expense of a short, sharp cycle in the real exchange rate and output. Under a pegged regime, there is less scope to achieve such overall macroeconomic tightening, and if a very severe fiscal contraction cannot be achieved, then this would raise fundamental questions about the sustainability of the exchange regime.

- A more forward-looking answer, but one which would need to be embraced at an early stage in order to be realistic, is that the boundary of macroeconomic and structural trade-offs in the economy can be pushed out over time. Through forceful structural and institutional reforms, policy-makers can make it safer to run the economy at high growth rates of domestic demand, with rising external liabilities, since sound market structures and institutions should elicit a swift and sustainable supply response. A central concern is that resources flow to efficient uses in the productive base of the economy, including crucially the traded goods sector. Through strong productivity growth this can enhance competitiveness, underpin income expectations, facilitate real exchange rate adjustment, and ensure that international liabilities are smoothly serviced. Careful analysis of the business environment is thus a key priority, since only this can provide a basis for policy-makers to press through targeted reforms.

A third set of complementarities and trade-offs concerns the scope to influence expectations and allocative decisions through ***action to enhance or change the institutional features of policy as well as, or instead of, the actual policy stance:***

Here, key issues arise in the design of fiscal frameworks, where a number of conclusions have been gaining wide recognition among economists. In essence, fiscal policy-makers usually face opportunities which, while politically difficult, can support the twin objectives of growth and stability. Well-targeted reforms can enhance public sector support for growth while facilitating consolidation. Strong fiscal institutions, meanwhile, can help buttress decision-making and guide expectations in ways supportive of stability. This will be particularly important when revenues are swollen by financial booms, further complicating the task of pursuing consolidation in "good times." Overall, the fiscal story is more of complementarities than of trade-offs, and institutions matter greatly.

The trade-offs relating to monetary frameworks are more complex. Experience in the region confirms that alternative monetary and exchange regimes, given adequate policy support, can perform very well in assuring low inflation. Much harder to evaluate are the risk characteristics of these regimes. This paper has argued that, in south-eastern Europe specifically, proponents of both fixed and floating regimes can easily underestimate the hazards facing monetary policy along the Accession road:

- Hard pegs have been associated in the region with credible overall policy management, and they insulate the economy from nominal exchange rate shocks. But they may accelerate the expansion of unhedged borrowing in foreign currencies, and they put a high premium on real sector flexibility in the case of shocks. Inflation dynamics, meanwhile, can raise questions about early euro adoption as an exit strategy from such pegs.

- Flexible exchange rates facilitate adjustment; and – as part of a co-ordinated policy effort – they may help to slow the growth of balance sheet risks. But to the extent such risks build up nevertheless over time, then these regimes offer no more than a qualified safety valve in the event of exogenous or policy-induced shocks.

In sum, complex trade-offs and complementerities face policy-makers during rapid financial development. Market distortions can be amplified, and policy errors can cause severe setbacks for growth. Such setbacks may take the form of a crisis or, at least as likely in this region, they may emerge as stresses that stall real convergence. So accelerated financial integration – a hallmark of the EU Accession process – places strong demands on policy-makers to ensure that institutions and market structures keep pace. An illustration of the way in which these demands may interact, and of the potential tensions they can create, is presented in Box 12.

Across south-eastern Europe, there are clear indications that the financial sector has the vigour, robustness and sophistication to 'deliver' in promoting accelerated real convergence. But there are also a number of policy watchpoints that deserve close attention if financial development and stability are to be assured over the medium term. The specifics, of course, differ significantly across the economies of the region. In each case, however, the challenge will be not only to identify the critical priorities for action, but to unlock the key complementarities that can assure sustainable growth.

Box 12: Policy tensions in a 'more advanced' South-eastern European transition economy

The country has a number of strengths. It is close to EU accession, the financial sector is foreign-owned, sound and robust. Prudential supervision and regulation follows best-practice. The country is officially an exchange rate floater and hence targets domestic price stability. Public sector finances are in relatively good shape as regards the fiscal balance and debt levels and the composition of spending is also efficient when compared with neighbouring peers. Capital accounts are open and the economy is benefiting from strong capital inflows, mainly in terms of FDI. Incomes are rising rapidly, and positive expectations of further catch up encourage increased private sector borrowing, notably by households, and result in a non-negligible current account deficit and rising private sector debt, of which a large part is in foreign currency. But, there are also vulnerabilities. Given still relatively shallow financial sectors, the monetary transmission mechanism of interest rate changes is rather weak. Moreover, despite being a 'good reformer' with a functioning market economy and near-complete privatization – structural initial conditions being extremely weak – the economy still faces a large number of real rigidities in labour markets and public finances; and weak institutional frameworks constrain formal private sector activity.

In such an economy, what would be the policy trade-offs and complementarities faced by policymakers?

Monetary policy would face numerous dilemmas. Avoiding a possible overshooting of the nominal exchange rate appreciation would be one, but at the same time, currency intervention can diminish the credibility of the inflation targeting regime, resulting in higher inflation expectations and asset price volatility. But increases in domestic interest rates might be ineffective: first, because higher returns could encourage capital inflows, further stimulating domestic demand pressures, FX appreciation and domestic imbalances; and second because of the still limited (albeit increasing) domestic transmission mechanism through the financial sector. That said, a flexible exchange rate offers a number of complementary attractions: it might discourage unhedged foreign currency borrowings and it would give incentives to develop hedging instruments and more complete foreign exchange markets.

Fiscal policy is somewhat less problematic in this country, given significant scope to counteract downturns and past reforms that have streamlined the civil service. That said, balances might currently be cyclically boosted, masking remaining weaknesses in composition and encouraging a relaxation of fiscal discipline, notably regarding public sector wages, pensions and transfers. Policymakers would have to balance out the benefits of a more equitable sharing of the growth proceeds with the costs of ratcheting up non-discretionary spending with significant downward rigidities. Increased fiscal consolidation on the other hand would take off some of the pressure on domestic demand and complement monetary policy. Furthermore, additional buffers would represent a useful safety valve to deal with future emergencies, such as currency or banking crisis.

In any country, structural reforms are particularly difficult to execute, if the pay-offs to policymakers are uncertain and long term, while the costs are immediate and borne by organized and politically influential interest groups. Moreover, in this case, as EU entry becomes a ‘fait accompli’ the external reform anchor would probably weaken. As a result, to improve the business climate, policymakers would focus on relatively easy tasks, such as reducing bureaucracy and procedures. More difficult would be improvements to governance standards, enforcement, property rights and labour markets where vested interests are powerful and pay-offs difficult to measure and hardly existent in the short run. For this economy however, the policy pay-offs in terms of fiscal policy, potential growth and enhanced financial stability would be considerable, given the incentives it would set for firms to register in the formal economy, pay taxes and have access to efficient and resourceful financial intermediaries.

Finally, there are prudential policies to consider. In a strict sense, their aim is to force deposit-taking banks to internalize potential externalities of bank failure. Given the fiscal and monetary policy constraints, policymakers here would probably want to experiment with ad-hoc prudential ratios (e.g. limits on unhedged exposures or mortgage lending) to counteract rapid credit growth – either with the view that banks’ current risk assessments underprice effective risk and/or with regards to macroeconomic stability. Yet, while such measures typically bite in the short term, in the long run it could leave behind a potentially more distorted, highly evasive and less efficient financial system. Given the sophistication of the financial sector in this country, it is also not clear that the government has better knowledge about financial sector risk than the institutions themselves. Perhaps a better way forward would be for supervisors, and policy makers more generally, to engage in the debate, flagging the risks and contributing their knowledge and research to this issue. This would include sharing prudential information cross-border with other supervisory agencies. Any cross-border gaps in the supervision of systemic risk also need to be addressed – including notably the need to ensure adequate asset diversification and sound funding structures in systemically important foreign bank subsidiaries.

8. Conclusions

This paper has considered the role of the financial sector during catching-up in the policy environment of EU Accession: the opportunities and risks inherent in accelerated financial expansion, and the challenges of capital-account driven real convergence. It has highlighted several dilemmas for policy makers. These include the difficulty of diagnosing risky credit booms in an environment characterized by equilibrium shifts in credit, asset prices and the real exchange rate; the difficulty of assigning policies to safeguard financial stability, without abusing them as a substitute for capital controls; and the difficulty of influencing the pace of credit growth or the level of the external current account deficit.

In an environment where policies may not have strong traction over credit growth, it is particularly important to put in place a lending environment and a business climate that foster productive investment and the expansion of the commercial sector, including small and medium-sized local firms. Competitive conditions on domestic markets, and an effective judicial framework, are key issues here. These factors should help to ensure a balanced pattern of economic and financial development. In south-eastern Europe, the structural challenges are typically greater than in the Baltic region and in central Europe. This is especially the case in the Western Balkans, given the fragmented nature of markets, the size of the informal sector, and delays in reform as a result of the regional conflict.

The prospects for sustained growth in the region, and also the extent of macrofinancial risks, will depend quite strongly on the pattern of sectoral development that financial expansion supports. If resources flow strongly to productive uses, including a robust development of the traded goods sector, this will help to boost productivity and competitiveness, and ease adjustment strains. Overall, it should result in a "flatter" cycle in the real exchange rate, external current account and net foreign assets – by comparison with a heavy shift of resources to non-traded goods, including housing investment, which could trigger much wider swings in such variables and potentially greater macrofinancial risks. In south-eastern Europe, there are some risks that the latter pattern could dominate, although across eastern Europe as a whole there are encouraging counter-examples.

EU Accession is seen as improving the chances of good outcomes through the scope for trade and investment integration, and institution-building under the *acquis communautaire*. But it should not be seen as “mitigating Asia-style risks” that are implicit in the presence of common lenders and unhedged foreign currency borrowing. Rather, it accelerates financial convergence through a decline in risk premia, the role of EU-15 banks, the pooling of economic sovereignty, and perceptions of a common euro destiny. This means that it raises the stakes on good policies by increasing economic opportunities, but also by amplifying the consequences of poor policy choices.

To avoid a crowding-out of private sector investment, and to contain macrofinancial risks, fiscal policy needs to focus on growth-oriented reforms in tax and expenditure policies, and on strong consolidation – priorities that are typically complementary. Particular vigilance is needed to ensure a tight fiscal stance during strong private sector booms: these are times when asset prices developments, the consumption richness of GDP, and the pro-cyclicality of potential growth estimates all flatter the apparent fiscal stance. This can easily led to a much easier underlying fiscal stance than intended.

As regards financial stability, it is important to be clear on the kind of stresses that could arise. The concern is not with financial volatility in its own right. It is that financial stress could connect to the real economy and cause a deep or enduring loss of output, stalling real convergence. This could be through a market crisis in the presence of balance sheet exposures. But, among recent convergence cases in the EU, the example of Portugal illustrates that – under hard pegs or monetary union – stress can also emerge directly as a growth crisis. Key transmission channels in such cases could be an overvalued real exchange rate and heavily leveraged balance sheets, which it takes time to address, especially in a setting where fiscal policy has not used good times to build flexibility.

This is a key consideration in countries that have “hard-wired” market stability through currency boards and foreign bank ownership, thus making a market-driven crisis a less likely initial channel of financial stress. The fiscal and structural priorities discussed in the paper are indeed particularly important under hard peg regimes. Such regimes may speed the pace of financial sector growth, and of foreign currency borrowing. They do so in a policy setting that helps to foster policy discipline and reduce nominal volatility. But by giving up monetary autonomy they also remove one instrument – albeit an instrument that may be only partially effective – for managing the convergence process.

The picture that emerges from this paper is thus one of great opportunity to harness accelerated financial development in the service of economic catching up, leveraging the positive support of the *acquis communautaire* and of economic integration with the EU. But it is also a picture that features considerable risks to growth – which could take different forms, depending in part on the monetary and exchange regime.

The challenge of managing rapid financial catching up is thus one that calls for risk-averse macroeconomic policies. But it also depends very importantly on strong structural policies. Structural reforms are key in fostering the expansion of the traded goods sector and other productive activities – and also in enhancing the capacity to switch resources between sectors and, more generally, to adjust the economy over time. The process of real convergence should then feature a balanced pattern of economic growth – with manageable external current account and real exchange rate dynamics during catching-up, and adequate adjustment capacity over the medium term. In this sense, the challenges of fostering sustainable growth and preserving financial stability, on the road to EU Accession, are entirely complementary.

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