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Delayed Recovery in the Balkans

The prospects for recovery in the Balkans are not very promising in the medium term. The main reason is that rather significant restructuring of product and labour markets are needed with a seriously constrained policy framework. The paper will discuss these three issues: growth prospects, structural adjustments, and the policy framework.

Ad. 1. In the pre-crisis period, growth was supported with the policy mix that neglected the growing vulnerabilities. The key anchor of macroeconomic stability was monetary policy that either targeted the exchange rate or inflation, but even in the latter case rather via an exchange rate anchor. In that context, low exchange rate risk led to relatively low credit and investment risk in general, which supported fast build up of debt – mostly private and foreign. In the post-crisis period, the process of deleveraging is slowing down the recovery. It is not clear how far this needs to go before the financial situation improves significantly. In any case, growth prospects in the medium run can hardly come from renewed inflow of foreign investment.

Ad. 2. The key structural problem of the Balkans is low exporting capacity. Most countries run significant trade (in commodities) deficits only partially attenuated by exports of services in some cases. In addition, the transformation of the labour markets has been slow and efficient as it has produced low levels of employment and high rate of unemployment and inactivity. Given the reliance on foreign financing that leads to three important restructurings:

(i) Financial: domestic savings have to increase in order to finance investments as the reliance on outside resources will be limited.

(ii) Production: the supply of tradable goods needs to increase in order to rely more on external demand for recovery and growth.

(iii) Labour: significant reforms of the labour markets are necessary in order to spur increased employment.

These structural changes will take time to be conceived and implemented. Also, given that these are structural shifts, market liberalization measures may prove not to be enough and other policies interventions will be needed, which may prove difficult. In some cases, e.g. Croatia, accession to the EU may prove temporarily helpful, but structural challenges will remain.

Ad. 3. The shift in the policy framework may prove to be rather challenging. In most Balkan countries the emphasis is on fiscal adjustment rather than on either structural reforms or

on monetary policy (i.e. the exchange rate policy). In the past, rigid monetary framework was seen as the insurance against reckless fiscal policy. Going forward, the rigidity poses additional strains on fiscal policy, which does not have all that much space to adjust. Structural reforms, on the other hand, are met with resistance both in the product and in the labour markets.

There is, in general, assumption that monetary and exchange rate policies are endogenous, i.e. cannot be really affected by local policy makers, while fiscal policy is considered to be under control, at least potentially, of the national governments. Also, structural reforms are seen as the problem of political will rather than being endogenous to social and even international processes. Thus, the pressure is put on the governments to be fiscally responsible and to implement labour and product market reforms that will boost growth.

It is not altogether clear that fiscal policy is not endogenous; and not only to the usual political economy considerations, but also to the prevailing policy mix. In fact, the rigid monetary policy framework has been argued for precisely because it would make fiscal policy endogenous to the concerns for its sustainability. This monetary policy dominance has proved not to be all that effective, but it has led to a loss of easy control of fiscal policy. In the post-crisis period, the regaining of control over fiscal policy is proving to be rather difficult. Though most of the countries have either adopted or are planning to adopt some type of fiscal rules based framework, usually called the framework for fiscal responsibility, most of the fiscal developments are basically driven by the financing needs of the households and the corporations and by the performance of the economy, i.e. the speed of the recovery or the lack thereof.

Given the problems inherited from the pre-crisis period and given the tall reform and policy agenda, the prospects for recovery in the majority of the countries in the Balkans are not all that encouraging in the medium run. The paper will include some speculations on the social and political consequences of the delayed recovery in the Balkans.