Neoclassicism in the Balkans

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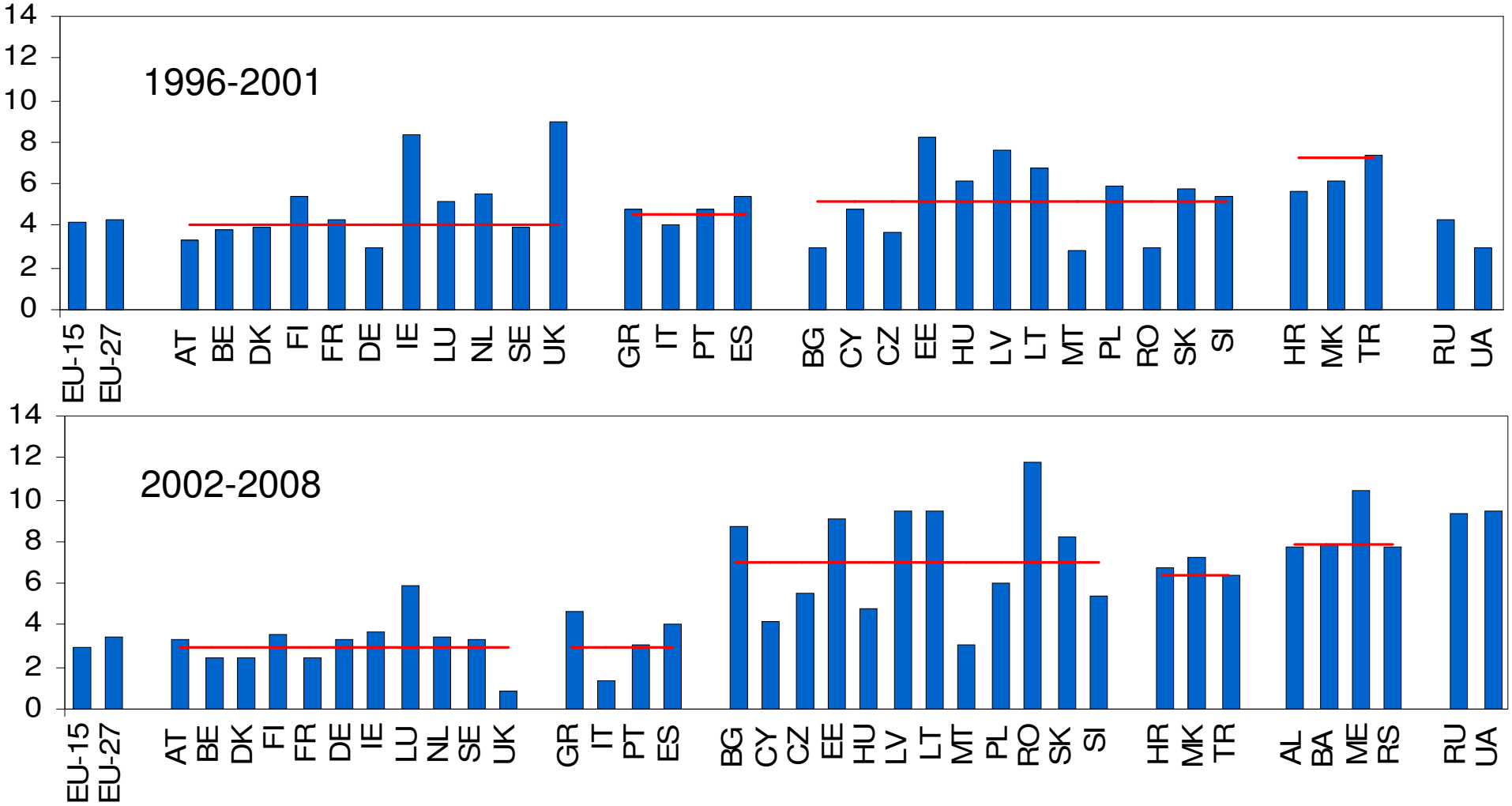
Neoclassical Growth> Stylized

- Foreign investment driven because of higher productivity in capital scarce countries
- Investments mostly in the tradable sector (i.e. industry)
- Trade and current account deficits initially large, but than closing down over time
- Foreign debt to GDP ratio should stabilize and start declining with the narrowing of the current account deficit
- Employment growth slow or non-existent for a prolonged period of time (productivity driven growth), but eventually strong
- Fiscal constraint lax

Growth – GDP per capita

Average annual growth rates, 1996-2001 and 2002-2008, in %



Source: wiiw Annual Database incorporating national statistics, Eurostat.

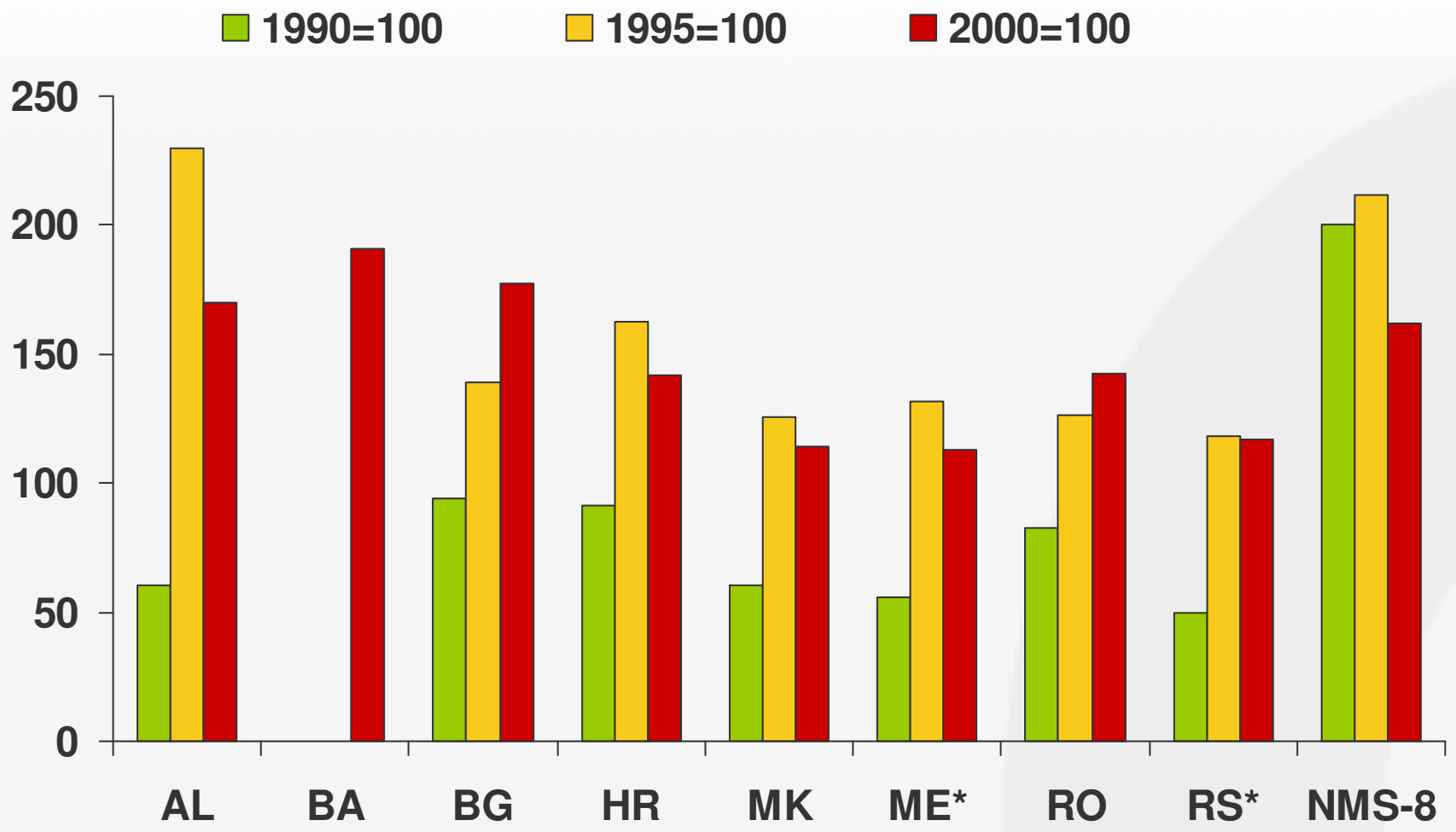
Key Condition

- The country should be an interest rate taker – the relevant world interest rate should apply
- E.g.> euro interest rate should be the anchor for domestic interest rates
- That implies that shocks should be absorbed by the exchange rate
- In the Balkans, as a rule, exchange rates are fixed and the arbitrage process in the money and the asset markets cannot function properly

Different Transition

- Underdeveloped tradable sector
- High trade and current account deficits
- Growing private and foreign debts
- Unreformed public sectors
- Depressed labour markets

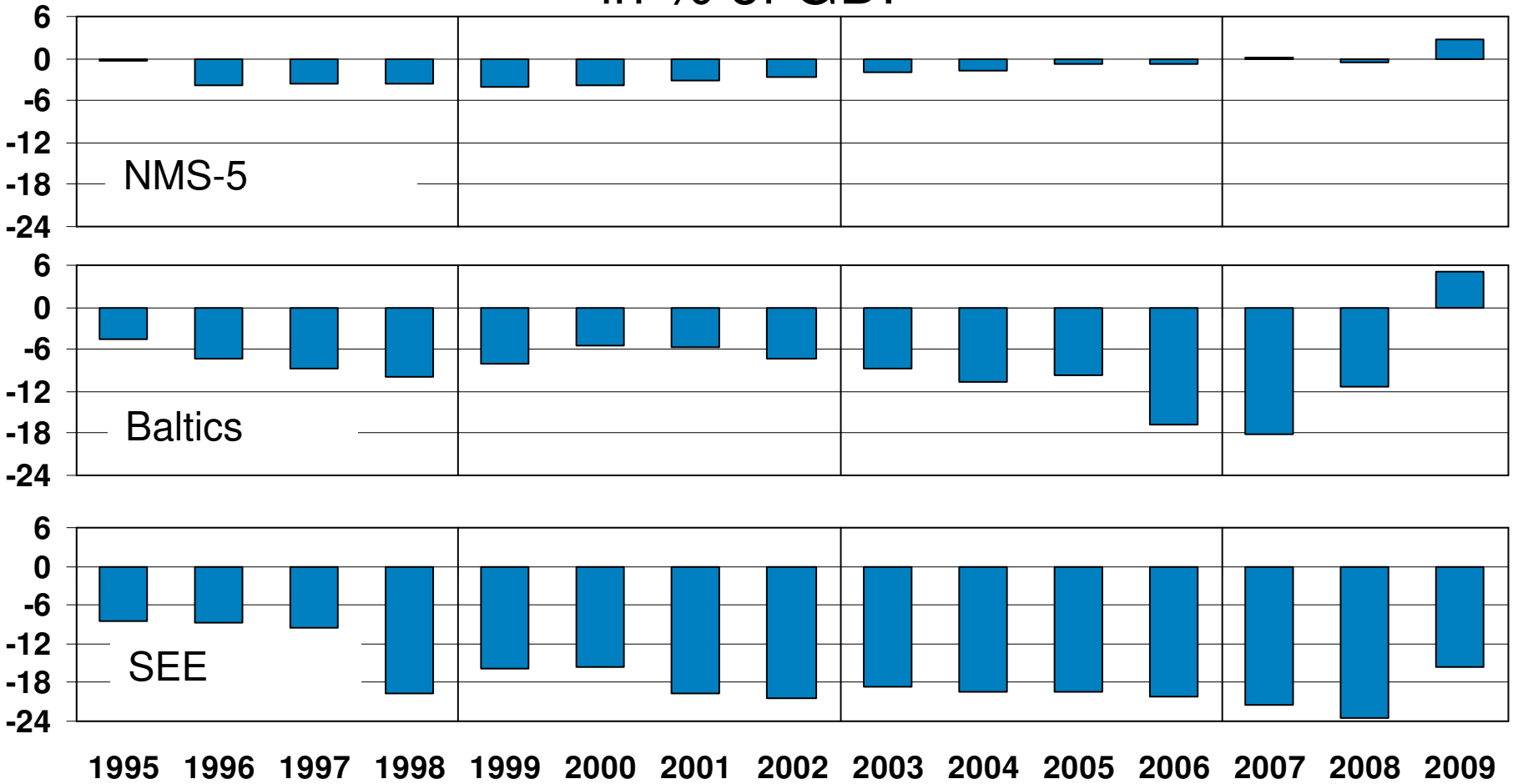
Industrial production, 2008



Note: Until 1998 data refer to Serbia and Montenegro.
Source: wiiw Annual Database incorporating national statistics.

Trade balance of goods and services (BOP)

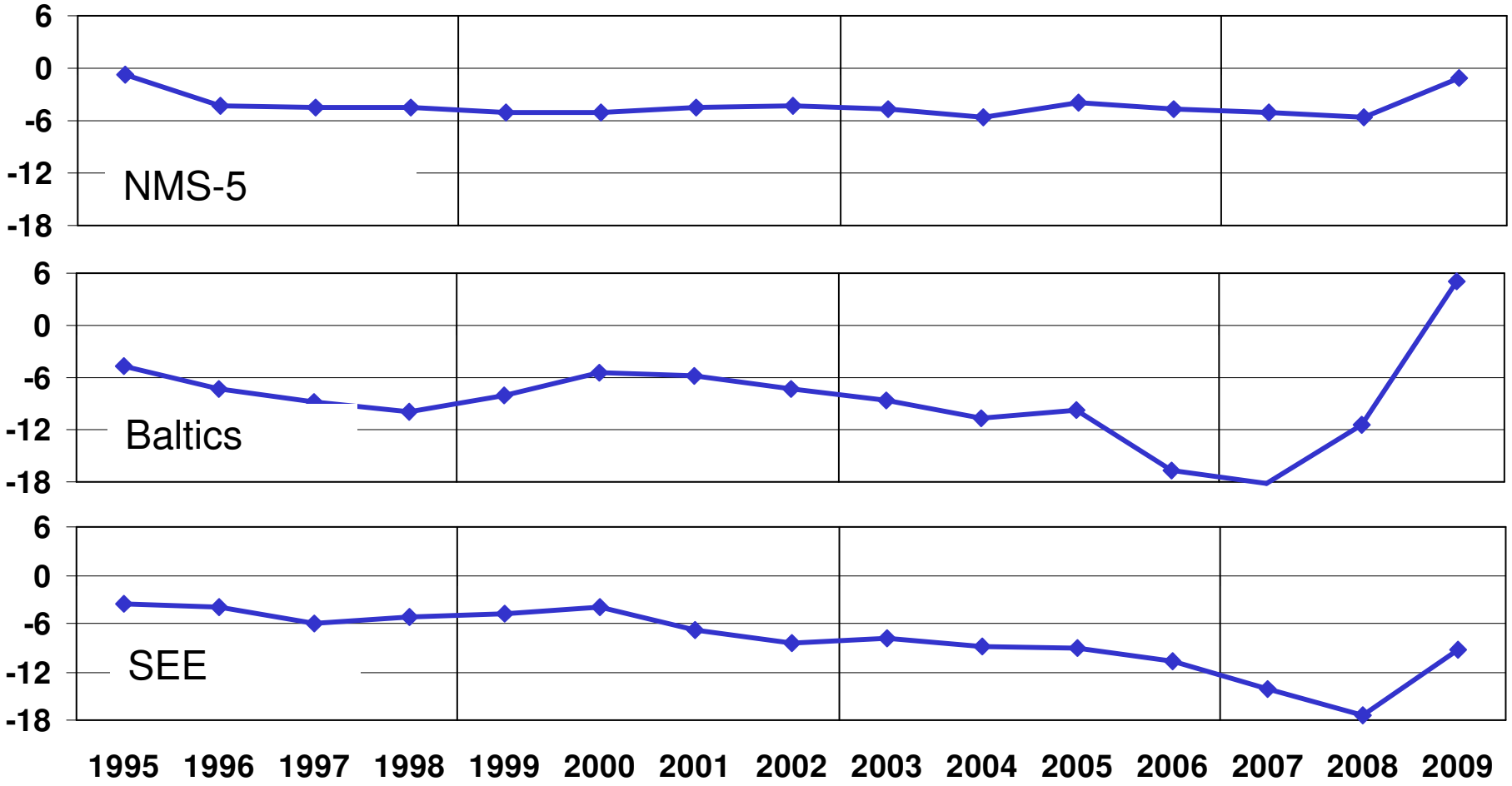
in % of GDP



NMS-5: CZ, HU, PL, SK, SI. Baltics: EE, LV, LT. SEE: BG, RO, HR, MK, BA (from 1998), RS (from 1999), ME (from 2001).
Source: wiiw Annual Database incorporating national statistics, Eurostat.

Current account

in % of GDP



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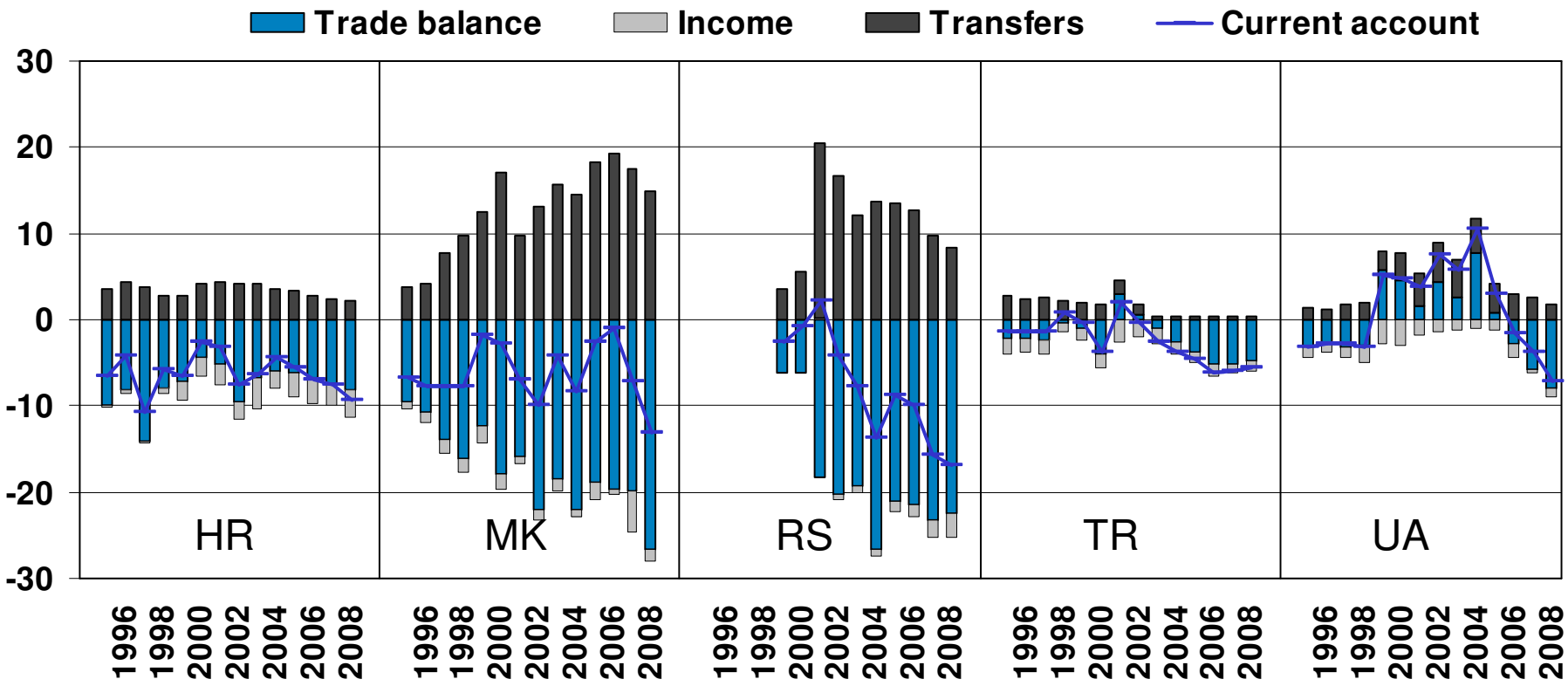
Trade balances of goods and services and income balances, 1995-2008

in % of GDP



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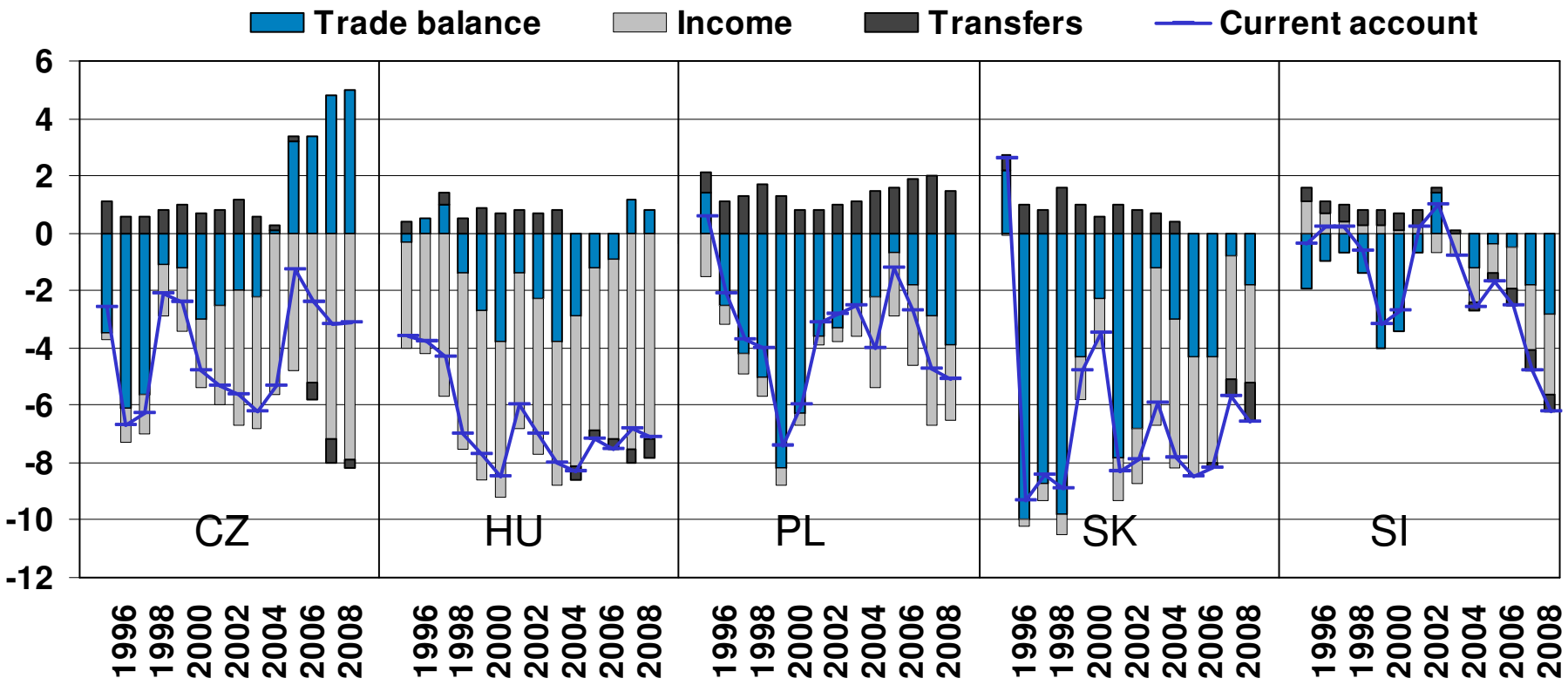

Source: Eurostat, wiiw calculations.

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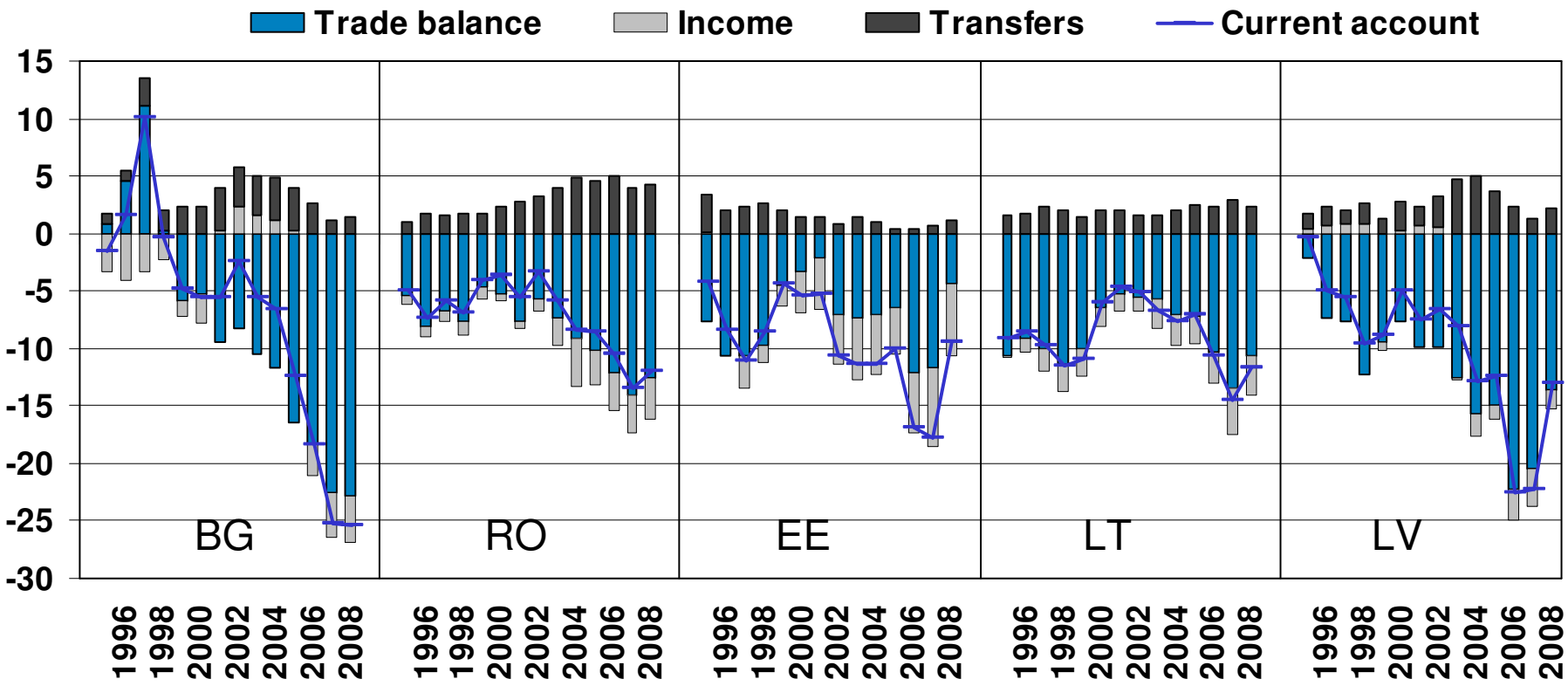
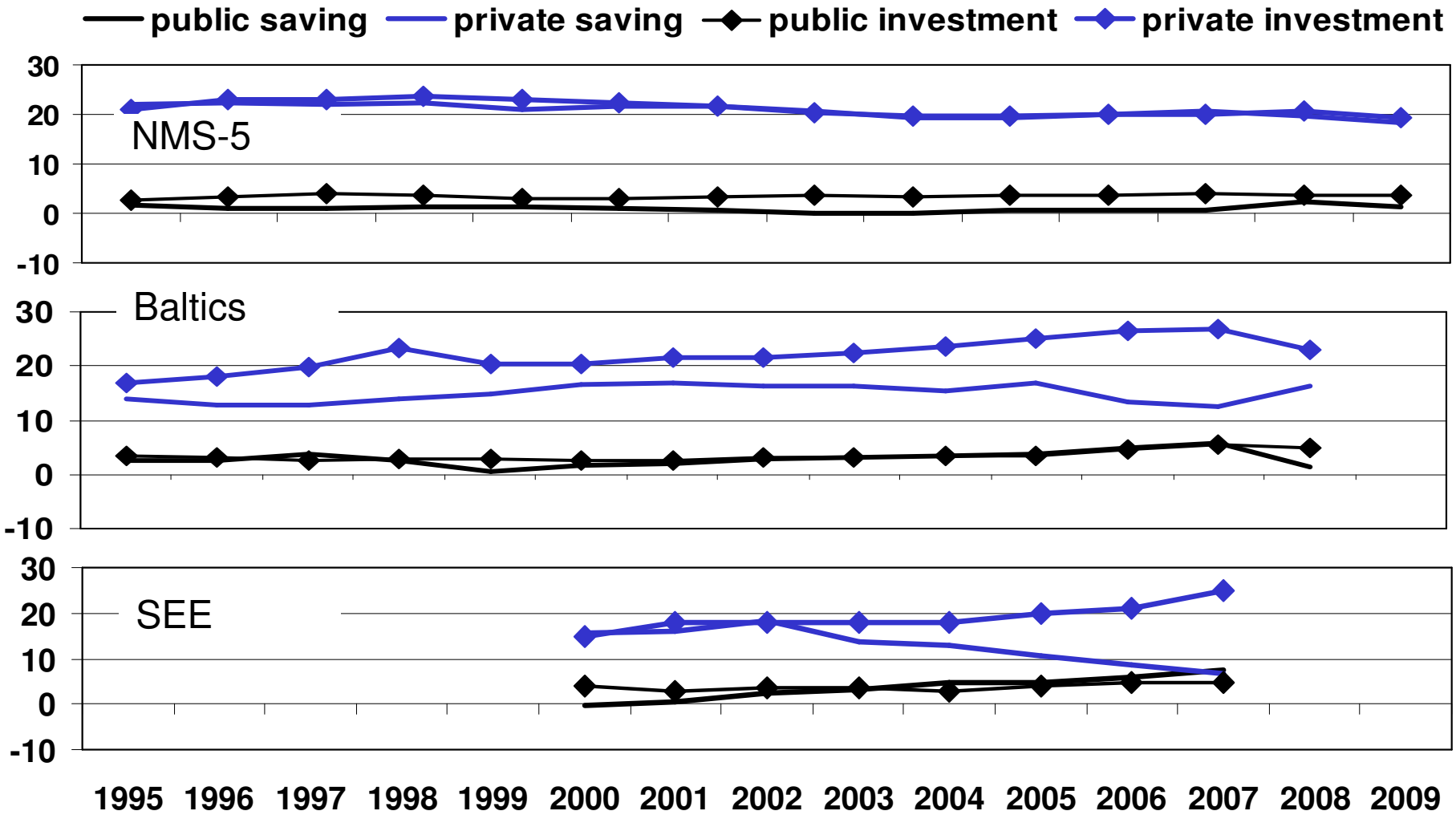


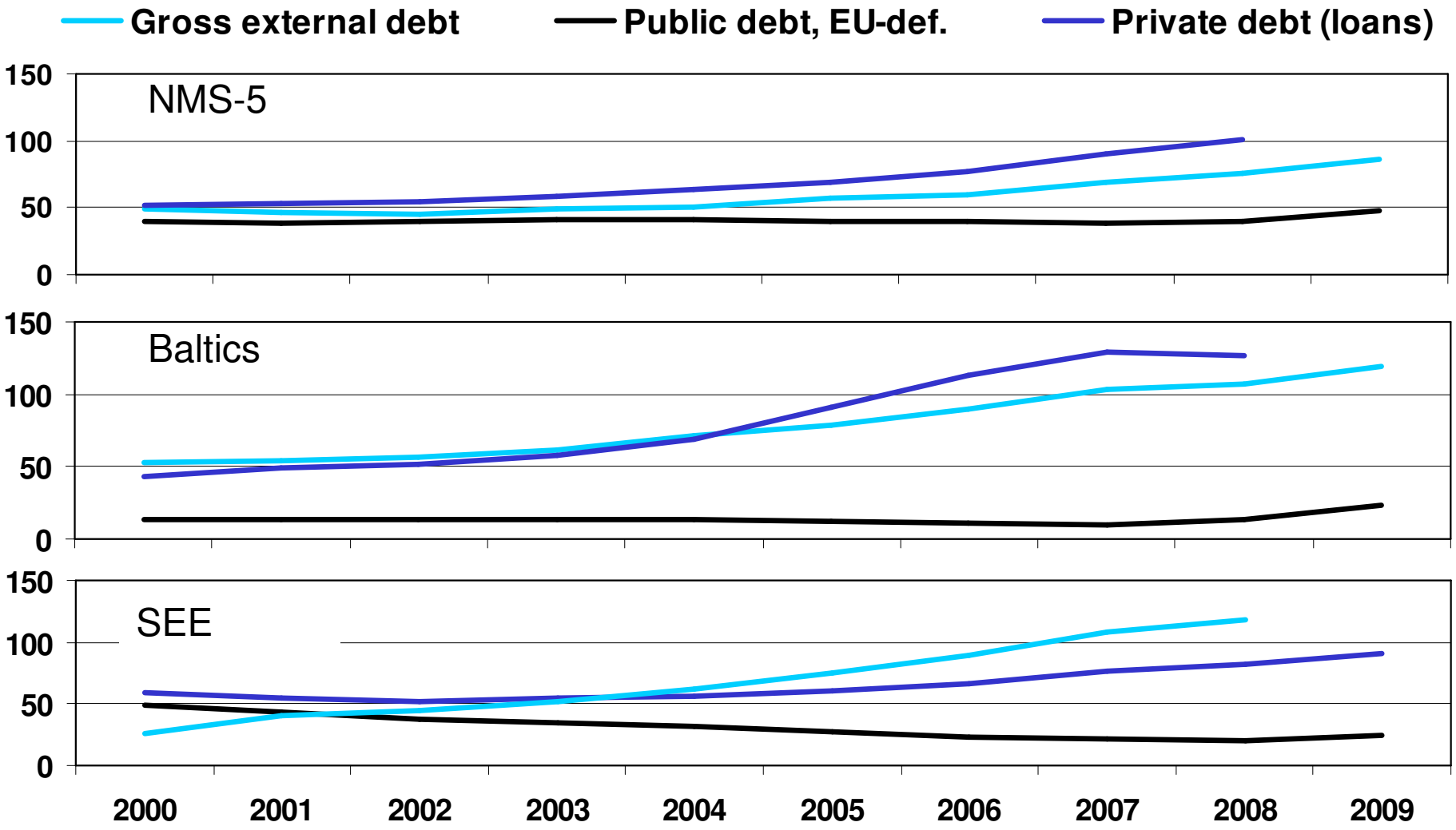
Source: Eurostat, wiiw calculations.

Savings and investment in % of GDP



NMS-5: CZ, HU, PL, SK, SI (from 2000-2007). SEE: BG (2000-2006) and RO (from 2004-2007).
Source: Eurostat, wiiw calculations.

Debt in % of GDP



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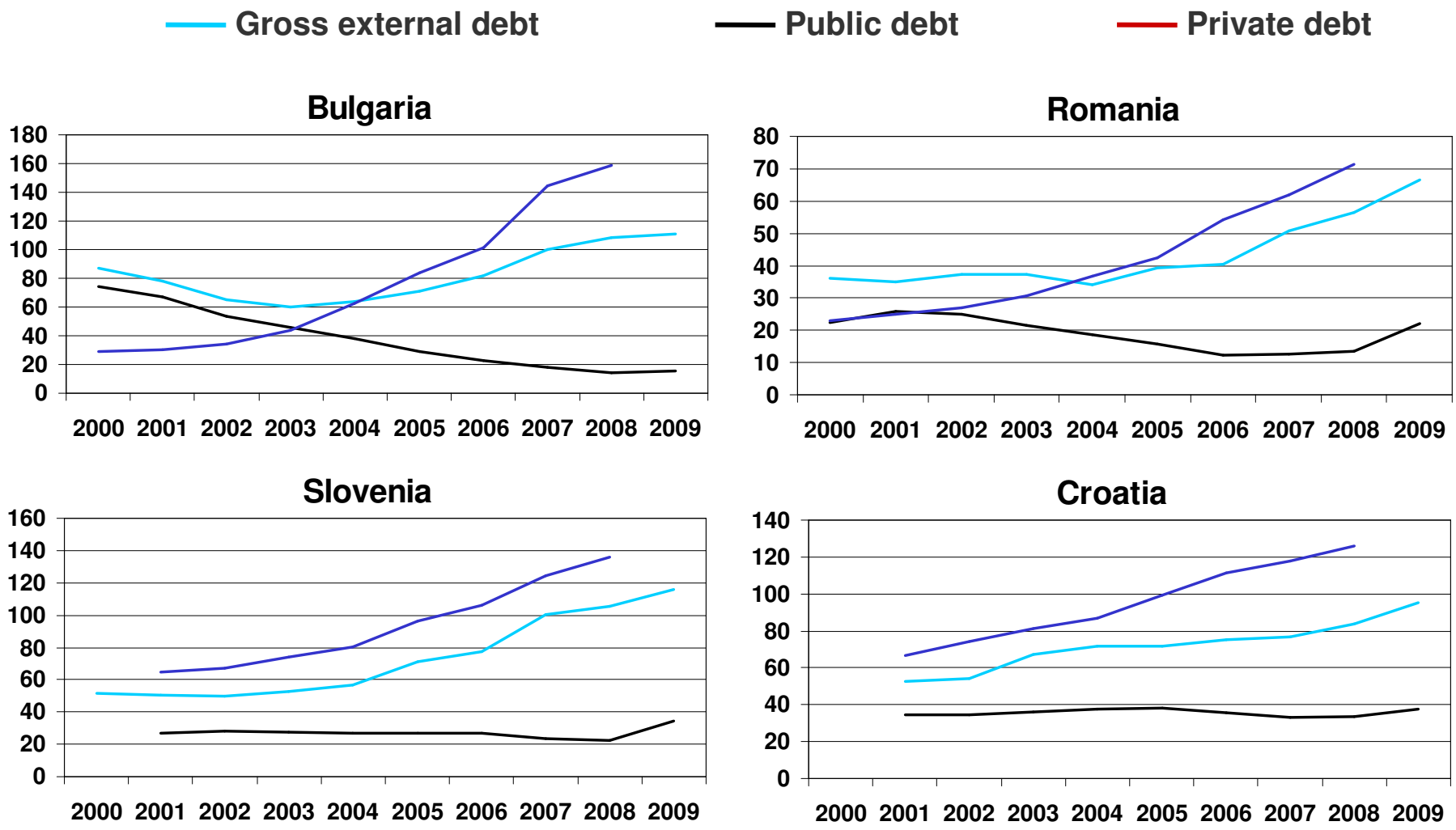
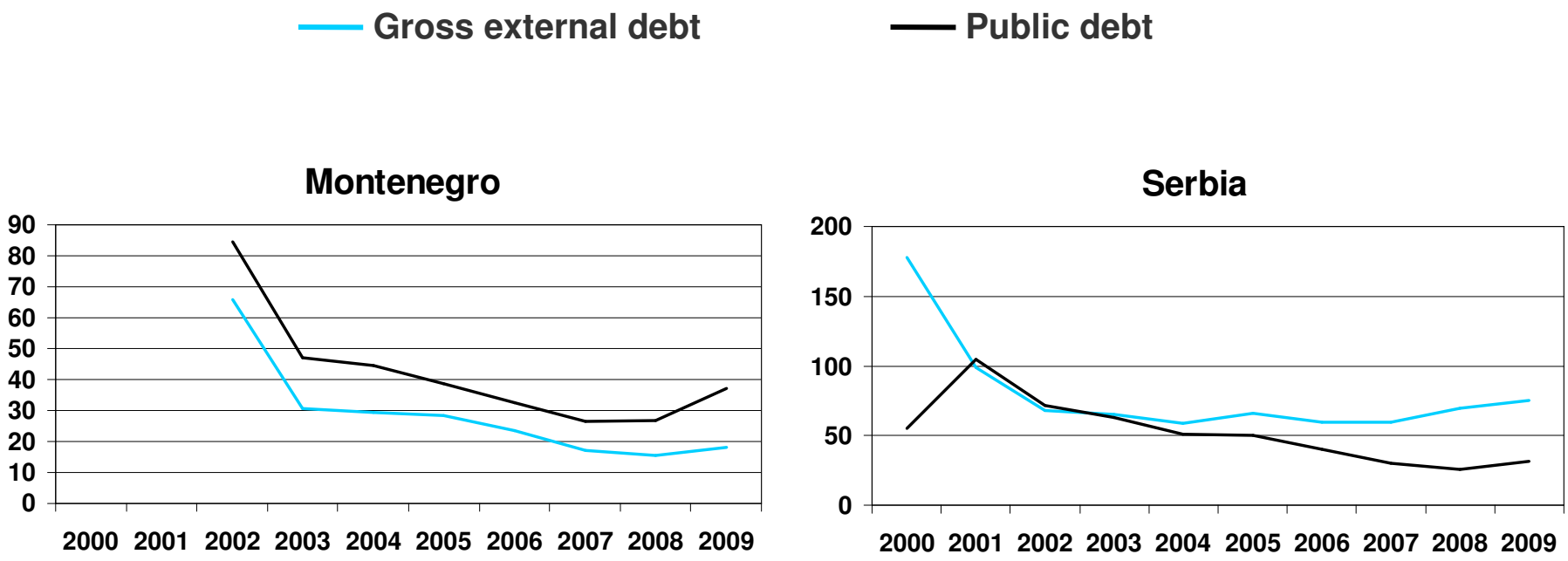
Debt in % of GDP



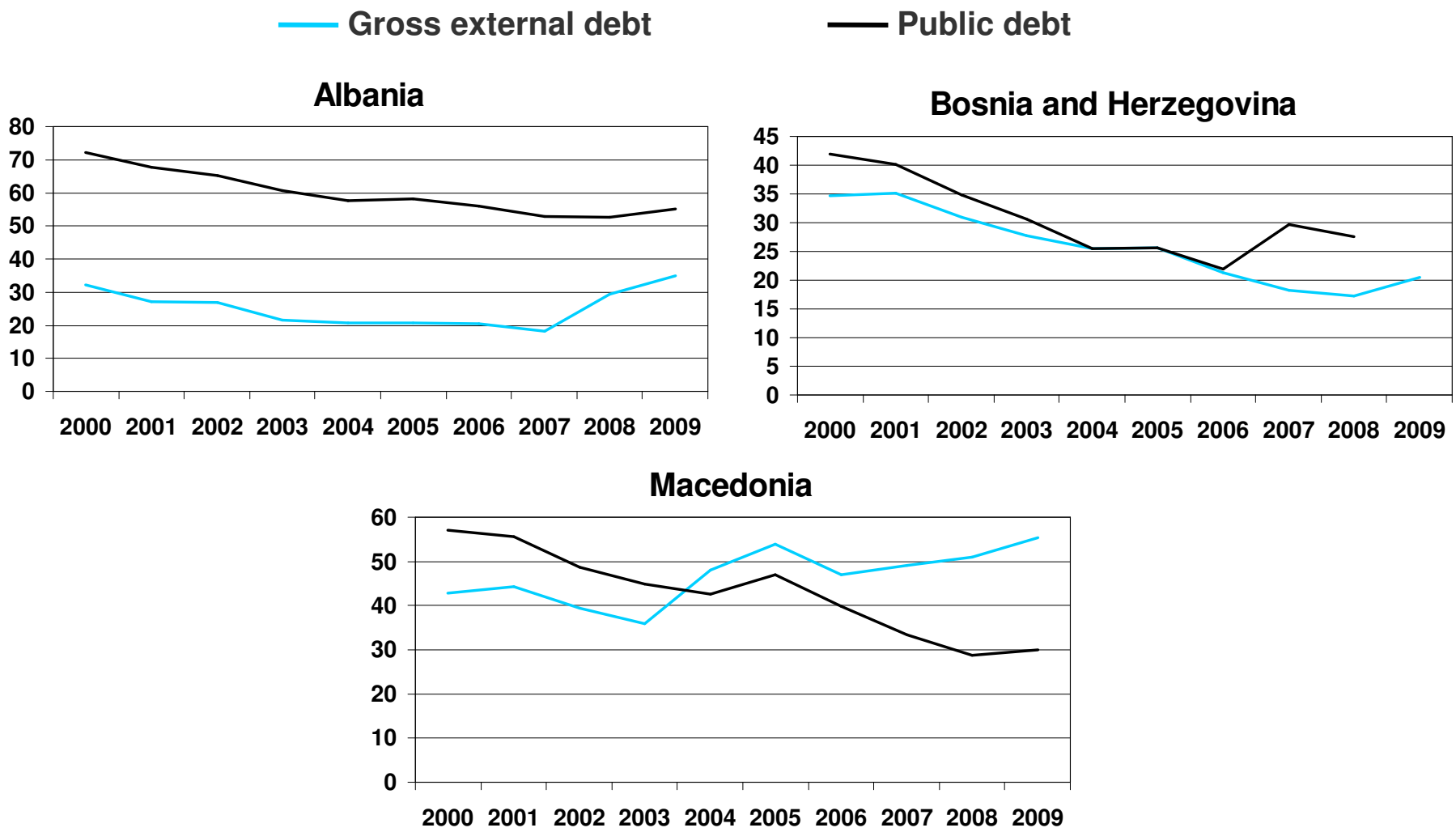
Source: wiiw Annual Database incorporating Eurostat statistics.

Debt in SEE in % of GDP



Source: wiiw Database incorporating national statistics.

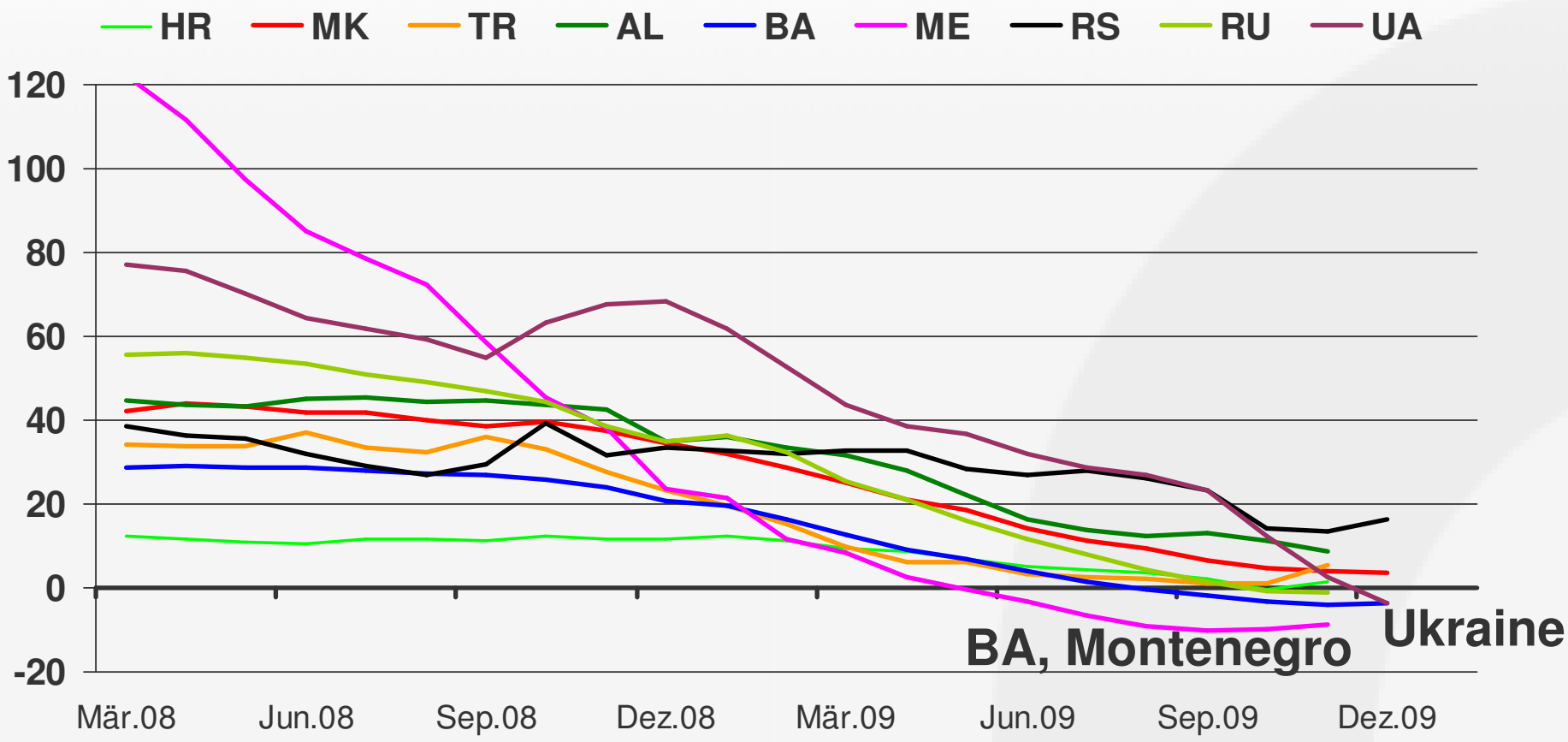
Debt in SEE in % of GDP



Source: wiiw Database incorporating national statistics.

Bank loans to non-financial private sector

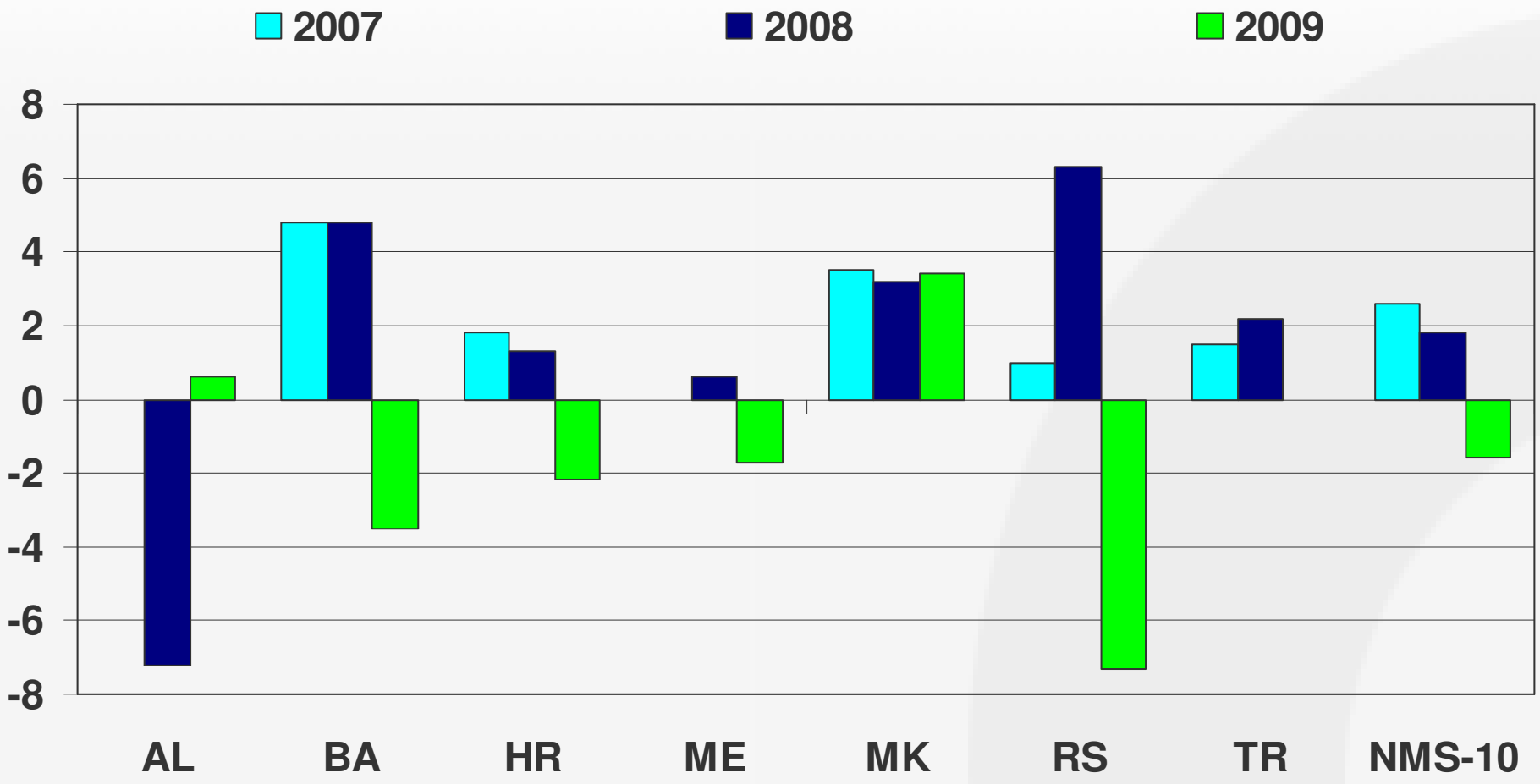
annual changes in %



Source: National Bank of the respective country, wiiw calculation.

Employment growth in SEE

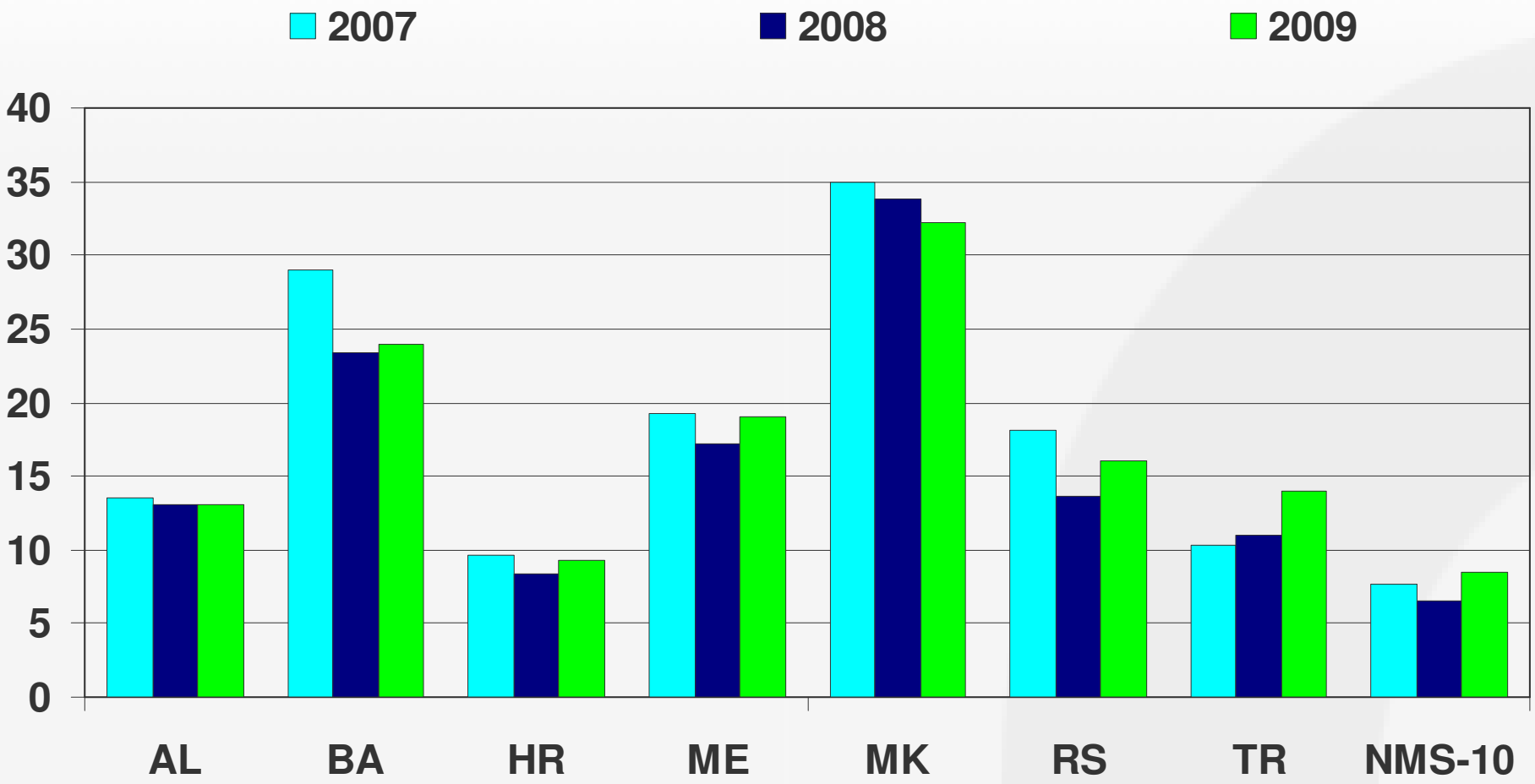
annual change in %



Source: wiiw Database incorporating national statistics, Eurostat.

Unemployment rates in SEE

in %, LFS



Source: wiiw Database incorporating national statistics, Eurostat.

A Problem and an Advantage

- Neoclassical growth requires openness – current and capital market liberalization – and labour market flexibility> that may lead to more volatility due to external and internal shocks
- The advantage is that fiscal constraint is lax because real interest rate on the debt tends to be below the real growth rate

Consequences

- Public and private savings tend to be low and consumption tends to be high
- However, social welfare is high and inequality does not widen dramatically

Growth in the Balkans

- Investments mainly in services, raw materials and metals, and some labour intensive industries
- Thus, tradable sector is weak
- However, savings are still low and unemployment is high

The Crisis and the Dilemma

- Even if the countries were at the initial phase of growth that is characterised by large external imbalances, the crisis has cut the stylized path short
- In addition, increased risks may become a permanent feature, which will mean that neoclassical growth will lead to stagnation
- The dilemma is whether to work on the reduction of risks or to change the growth paradigm? The alternative is some version of mercantilism

Policy Challenges

- Assuming that a switch to mercantilism with high savings and current account surpluses is not manageable
- There is still the need to significantly strengthen the tradable sector
- Which implies, in the first place, a real exchange rate adjustment
- Which, however, is hard to do via nominal devalutation because of high euroization

The Alternative

- Risk reduction measures
- Public sector restructuring
- Regional investments

The Outside (I)

- IMF could be useful if it were to provide a framework for real exchange rate depreciation through nominal devaluation
- Otherwise, high risk of external and internal shocks are not something that the IMF can address with its instruments

Outside (II)

- Multilateral creditors would be helpful in development projects and in support of entrepreneurship
- There will be investment gap and creditor risks that they could fill and take on

Outside (III)

- The EU main role is to stabilise long term risks with accession policies
- In the medium term, IPA funds should play an important role
- Also, medium term fiscal planning can address some of the main internal shocks
- The short term external shocks are more difficult to handle – though the euro anchor would be useful

Conclusion

Structural adjustment will be needed with a rather rigid policy framework

That is, main support should be expected from structural reforms

That could lead to slow recovery over the medium term

There are social and political risks to that scenario