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South East Europe Six: From Double-Dip Recession to Accelerated Reforms

South East Europe Regular Economic Report Team

This note discusses the external environment, economic outlook, and key policy challenges for the six South East European Countries (SEE6)—Albania, Bosnia and Herzegovina (BIH), Kosovo, the former Yugoslav Republic (FYR) of Macedonia, Montenegro, and Serbia—as they seek to reignite economic recovery. After two years of fragile recovery from the global recession, as a group, SEE6 countries experienced a double-dip recession in 2012. Deteriorating external conditions, the impact of the severe winter on economic activity, and a continuing rise in unemployment early in the year took a toll on consumption, investments, and exports. The rise in unemployment continues to threaten the social fabric. Credit recovery and fiscal consolidation are under threat. Nonperforming loans (NPLs)—thought to be stabilizing only a few months ago—are again on the rise. As a result, both within and outside the region, the environment has become much more difficult to navigate, and the policy trade-offs necessary to stabilize economies and reignite growth have become more difficult to make. To overcome these challenges, SEE6 countries need more intensive policy reform to reduce public debt and accelerate structural reforms, especially in fiscal consolidation and the financial sector, labor markets, and business environment. Additional external financing from international financial institutions (IFIs) for growth and jobs could prove effective, but only if accompanied by intensified fiscal and structural reforms.

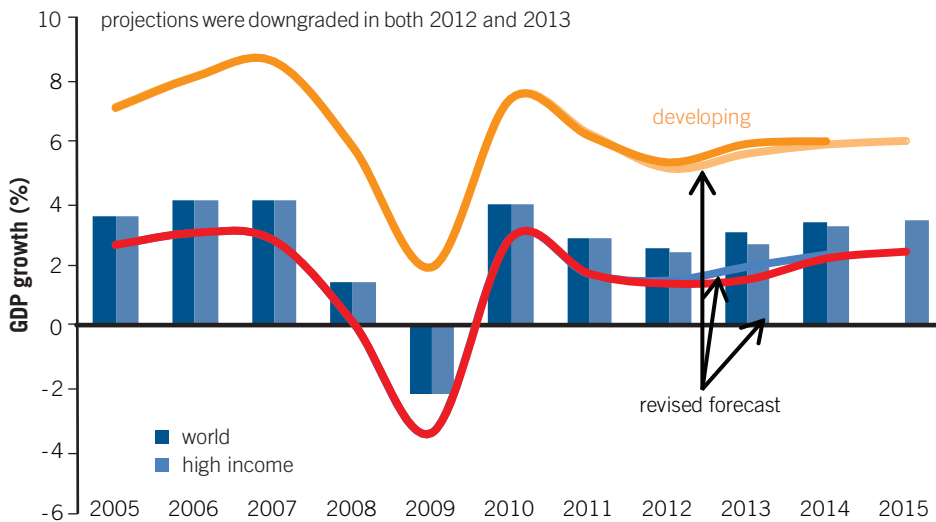
External Environment

After months of decelerating economic activity following turbulence in financial markets in the second quarter of 2012, global economic activity is slowly picking up once again—most notably in developing countries. But the modest rebound is tenuous. The latest data show declining growth in industrial production in the world's two largest economies, the United States and Japan. Due to mid-year weakness, calendar year global gross domestic product (GDP) growth projections are being tentatively downgraded by about 0.2 percentage points to 2.3 percent in 2012, and by 0.6 percentage points in 2013 to 2.4 percent, mainly because of the recession in the eurozone (figure 1). Threats to the recovery include the difficulties of implementing eurozone fiscal consolidation; remain-

ing global uncertainty; and the risk of an uncontrolled unwinding of China's high investment rates. To further complicate the situation, low stocks of maize and wheat could result in even higher food prices, with serious consequences for the poor.

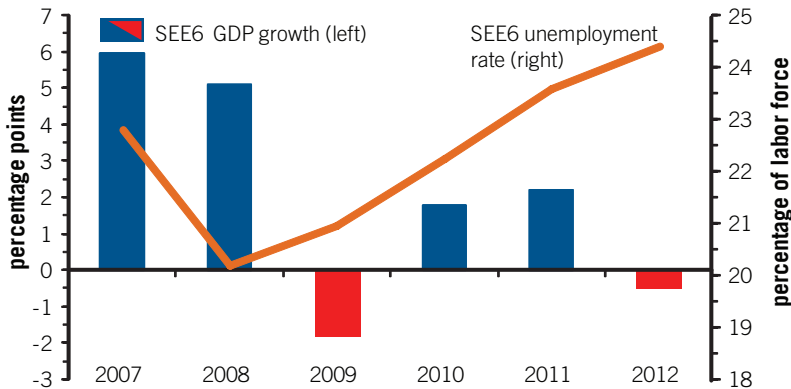
These global and eurozone developments are adversely affecting the SEE6 countries, primarily through foreign trade, financing, and remittance channels. After growing by about 2 percent annually in 2010–11, the combined real GDP of SEE6 will shrink—to 0.6 percent in 2012, with real output in Serbia declining by as much as 2 percent. With weak economic activity, the unemployment rate in SEE6 countries, already among the highest in the world, keeps rising (figure 2). Also, it is now clear that even in the best of circumstances, the road

Figure 1. External Environment: Clouds on the Horizon



Source: Global Economic Prospects 2012.

Figure 2. Double-Dip Recession, Rising Unemployment



Source: Bogetic and others 2012.

to sustained recovery will be arduous and the risks may be formidable. Among the main clouds on the horizon for 2013 are the uncertain recovery of the eurozone and high commodity prices—risks to which all the SEE6 countries are highly vulnerable. Also worrisome for SEE6 households is the risk of a new food price shock, which could exacerbate poverty and put pressure on the middle class.

The SEE6 region as a whole remained in a recession during 2012, with growth in 2013 expected to be sluggish at 1.6 percent (table 1). Growth is expected to recover because of a bounce back in agriculture, increasing auto exports from Serbia, and some easing of external and domestic demand conditions. Growth in 2013 is projected to be lowest in BIH (0.5 percent), and fastest in Kosovo (3.3 percent). Serbia's economic growth is expected to reach about 2 percent in 2013, driven mainly by accelerated exports and the value chain from the large Fiat factory and by a cyclical agricultural bounce back. But growth will not be enough to

make a dent in high unemployment, which might continue to rise.

After two years of deep crisis, a sluggish recovery, rising unemployment and poverty, and a continuing recession—even with the best efforts on fiscal consolidation and structural reforms, which must continue—there is a danger that SEE6 countries have been caught in a vicious circle that reinforces the cycle of long-term austerity, low if not negative growth, high debt, and even higher risks of social upheaval. In this difficult environment, SEE6 countries are facing tough policy challenges in order to maintain stability while promoting recovery.

Fiscal and Structural Challenges

Some of the obstacles that SEE6 countries must address are major fiscal and structural challenges. In the *fiscal* area, Serbia, Albania, and Montenegro in particular will need to persevere in their efforts to reduce fiscal deficits and public debt, even as they must continue to improve their investment climates and reform labor markets and their public sectors (figure 3). Also, in all SEE6 countries, public sector arrears pose special challenges for fiscal management and the private sector, and there are unfinished structural reforms agendas.

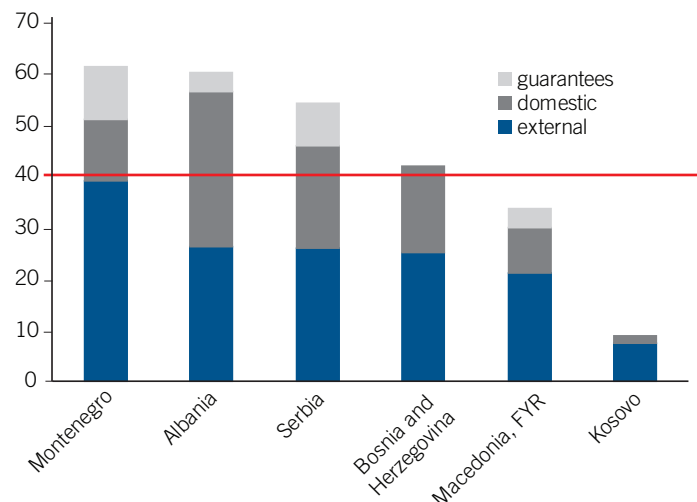
On the *financial sector* front, the good news is that through a combination of early reforms, the region avoided meltdowns during the global crisis, although a large agenda remains. While the impact of the eurozone crisis

Table 1. SEE6 Growth Outlook for 2012–13 (in percent)

	2011	2012 (estimate)	2013 (projection)
Albania	3.0	0.8	1.6
BIH	1.3	0.0	0.5
Kosovo	5.0	3.6	3.3
Macedonia, FYR	2.8	0.0	1.0
Montenegro	3.2	0.2	0.8
Serbia	1.6	-2.0	2.0
SEE6	2.2	-0.6	1.6
EU-11	3.1	0.9	1.3
Euro area	1.5	-0.4	-0.1

Source: World Bank, for EU-15, European Commission.

Figure 3. Public Debt in SEE6 Countries (percent of GDP)



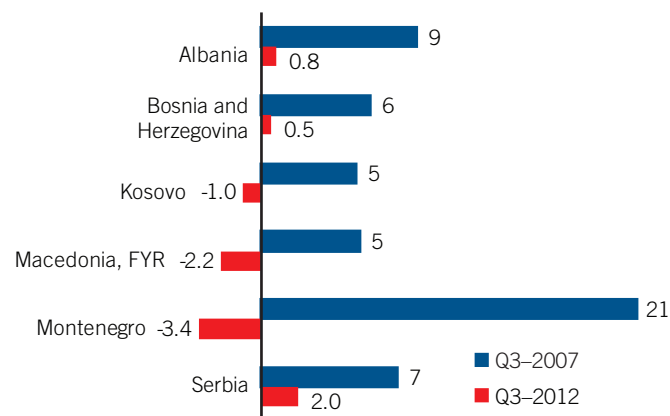
Source: Bogetic and others 2012.

has been contained to date, SEE6 banking systems are still characterized by rising or already high NPLs, low credit growth, eroding capital, and minimal profitability. High levels of NPLs mean that loan quality has deteriorated, and banks have chronic difficulties in writing off NPLs because ineffective insolvency regimes generally preclude rapid resolution of problem loans. The recent rise in NPLs has also limited the appetite as well as the ability of banks to resume lending. Moreover, bank loan-to-deposit ratios remain above 100 percent in BIH and Serbia, reflecting a small domestic deposit base and relatively high dependence on wholesale funding (figures 4 and 5).

In the area of *labor markets*, high unemployment is a major economic and social challenge for the region (figure 6). Kosovo, with unemployment at 43.5 percent, FYR Macedonia's unemployment at 31 percent, and BIH's and Serbia's unemployment at about 28 percent, are outliers in Europe as a whole and also rank high globally. According to the World Bank's World Development Indicators, few countries in the world have unemployment rates higher than 25 percent. As mentioned in previous issues of this report (Bogetic and others 2012), youth and long-term unemployment are particularly daunting problems for SEE6 countries. A prolonged economic downturn would add to the already persistent problem of long-term unemployment.

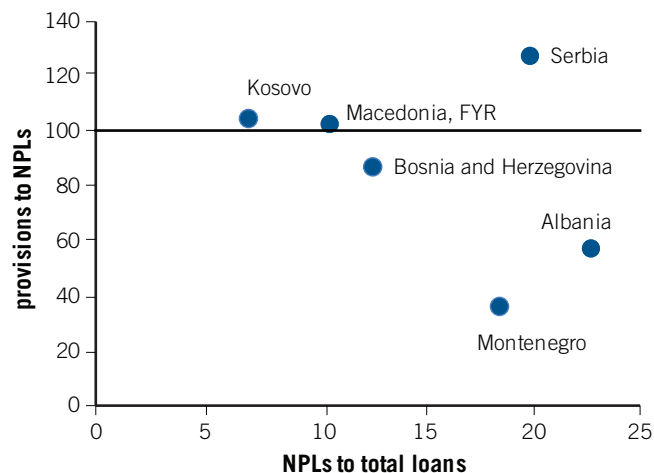
Are labor regulations to blame for the poor performance of SEE6 labor markets? The answer seems to be partially yes, although broader issues related to the structure of economic growth and competitiveness gaps also contribute to SEE6 poor labor market performance. In countries where the majority of jobs are created by the private sector, labor regulations can facilitate or impede job creation and wage earnings. Labor markets need to be regulated to protect workers from unfair treatment and ensure efficient con-

Figure 4. Credit Growth (% change, Q-on-Q)



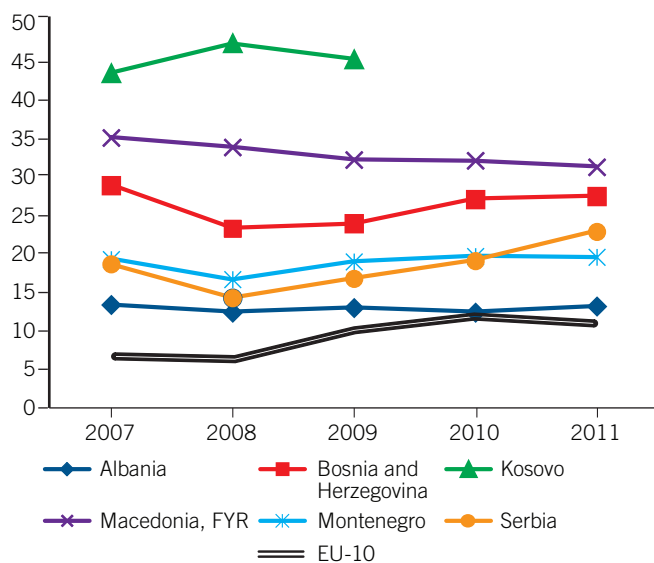
Source: IFS.

Figure 5. NPLs (% of Total Loans) and Provisioning (% of NPLs, 2012 Q3)



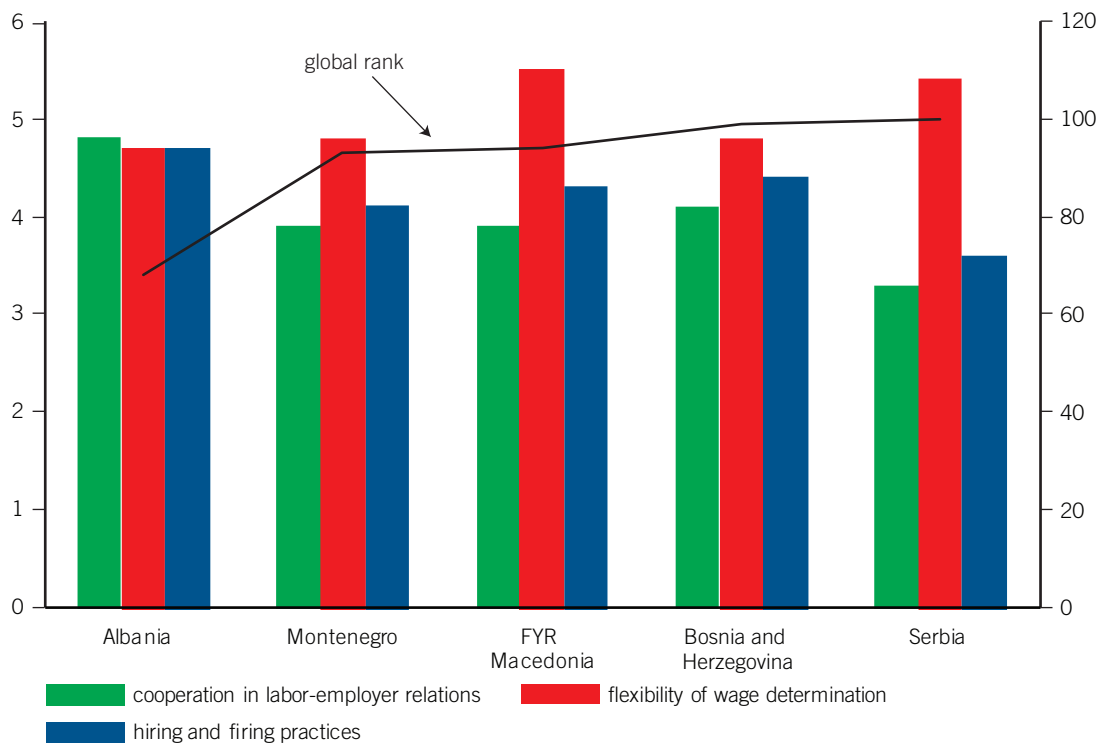
Source: IMF and central banks.

Figure 6. Unemployment Rates in SEE6 Countries



Source: Bogetic and others 2012.

Figure 7. The World Economic Forum Labor Efficiency Index, 2012–13



Source: World Economic Forum.

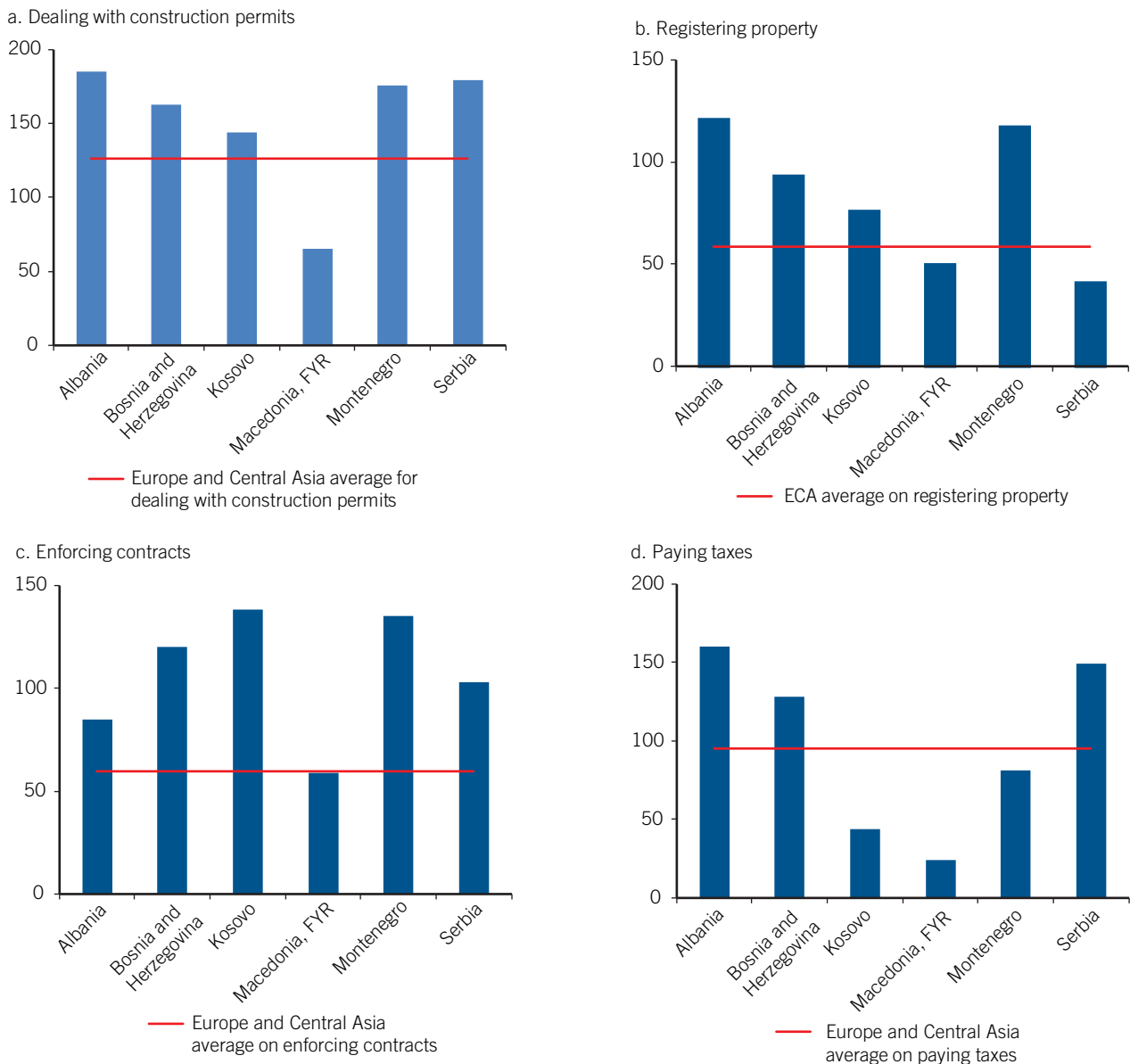
tracting between employers and workers. Excessive regulations, however, may go beyond addressing market distortions and constrain job creation. So where are the SEE6 countries on the regulatory spectrum? One indication is provided by the World Economic Forum’s (WEF) Global Competitiveness Index, which captures labor market regulation. The labor efficiency index, one of 11 subindexes, assesses the efficiency and flexibility of the labor market. It consists of four areas, three of which collect perceptions, while the fourth—on redundancy costs—covers labor legislation. Clearly, SEE6 countries (except for Kosovo, which is not covered) rank relatively low on regulatory efficiency (figure 7). Albania, 68th out of 144 countries, ranks highest; the other four all rank between 93rd and 100th. Among neighboring countries, Bulgaria is ranked 45th, Croatia 106th and Romania 124th. Excluding Albania, the other four SEE6 countries score lowest on cooperation in labor-employer relations, followed by hiring and firing practices.

Finally, *business environment* indicators have shown improvement in SEE6 countries, especially in areas such as starting a business, dealing with construction permits, and ease of paying taxes. However, the rankings of the six countries based on the Doing Business indicators range widely and much work clearly still needs to be done for these countries to become more attractive destinations for domestic and foreign investments. Country-specific investment climate surveys

show a similar picture. The average ranking of SEE6 countries lags significantly behind that of the EU-11, highlighting long, unfinished agendas.

The unfinished agenda in the business environment of SEE6 countries corresponds to their areas of weak performance on the Doing Business scale (figure 8). Interestingly, those weak areas—largely common to all SEE6 countries—relate to business regulations governing property transactions, the housing and construction industry, and enforcement of contracts. But FYR Macedonia has managed to improve many dimensions of its business environment, showing that it can be done in other countries in the region too. Also, some SEE6 countries fare relatively well in terms of ease of paying taxes. But it is important to stress that while these indicators capture certain aspects of the regulatory and legal environment, there are other aspects of investment climate and business practices that can be important for investment and growth, for example, quality of infrastructure and inequities in the tax treatment of formal and informal firms, which can be significant impediments to domestic and foreign investment. SEE6 countries should interchange best practices in legal and regulatory environment as well as other aspects of the investment climate so that ranking improvements can be comprehensive and faster. This is important not only to attract foreign investors, but also to serve as a benchmark for reforms and promote growth.

Figure 8. SEE6: Weak Areas in the Business Environment, 2012



Source: Doing Business Indicators 2013.

The Path Forward: Accelerating Reforms and Mobilizing Financing

Given the fiscal and structural challenges, what is now needed is more intensive policy reform in SEE6 countries to reduce public debt and accelerate structural reforms, especially in the fiscal and financial sectors, labor markets, and investment climate. If such accelerated reforms materialize, external support—well coordinated and targeting the region as a whole, not just individual countries—from the European Union and global IFIs could help ease the transition to more sustained growth in the medium term.

In November 2012, the European Investment Bank, the European Bank for Reconstruction and Development, and the World Bank announced €30 billion in financing for Cen-

tral and South East European countries over the next two years. In SEE6 countries, this timely initiative would likely be delivered via the Western Balkans Investment Framework (WBIF) and other IFI resources. European Instrument for Pre-Accession Assistance (IPA) resources will also be important, especially in supporting institutional reform and rural development. By focusing on major infrastructure of regional significance (rail, highways, energy, and gas) and on jobs and small and medium enterprises, the efficiency of investments, growth, and employment could be substantially heightened. However, additional financing for growth and jobs might prove effective only if accompanied by intensified fiscal and structural reforms, especially in the areas of investment climate, labor markets, and governance.

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on energy infrastructure, and *Javier Suarez* on lessons of privatizations.

Note

1. This note is drawn on Bogetic and others (2012).

Reference

Bogetic, Zeljko, Dilek Aykut, Damir Cosic, and others. 2012. "South East Europe Regular Economic Report No. 3: From Double-Dip Recession to Accelerated Reform." World Bank Policy Research Working Paper No. 3, Washington, DC.

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