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Macroeconomic Challenges with EU Accession in Southeastern Europe: An Overview

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Abstract

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The paper reviews key macroeconomic challenges with EU accession in Southeastern Europe (SEE). Most of the countries in the region are years away from EU accession and need substantial progress to meet the key macroeconomic criteria—the establishment of a functioning market economy and macroeconomic stability. The former calls for further structural reforms. While macroeconomic stability is essential throughout the EU accession process, the importance of specific outcomes increases in the last stage of accession, when countries face decisions to apply for entry into the ERM2 and the Maastricht criteria (Bulgaria and Romania). The main challenges with establishing macroeconomic stability in other countries are related to sustainability of their monetary frameworks, risks from rapid financial deepening, and further fiscal consolidation to support growth and stabilization. Most of the SEE countries have room to lower public spending and increase the share of pro-growth spending.

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Contents

I. INTRODUCTION

To accede to the European Union (EU), countries need to meet a number of economic, political, and legal criteria.[2] The purpose of the economic criteria is to ensure that when countries join the economic union, they have reached a level of development that enables them to function in a pan-European competitive environment. For countries in transition, the formal economic accession criteria has focused first and foremost on the establishment of a functioning market economy. While macroeconomic stability is important at all stages of accession, the weight of macroeconomic criteria in the formal accession process increases towards the end, when countries upon membership prepare to join the monetary union and adopt the euro. This suggests that the formal accession process puts more emphasis on progress with transition reforms at early stages of accession, as countries struggle to establish market economies, while compliance with specific macroeconomic stability criteria prevails in later stages.

The formal economic accession criteria translate into progress with so-called real and nominal convergence. Progress with market reforms can be measured by various indicators of transition. These reforms are important to advance real convergence, or growth of incomes towards EU levels, which helps countries to better withstand competitive pressures in an economic union. Macroeconomic stability, and later nominal convergence of key macroeconomic indicators such as inflation and fiscal deficits towards EU levels, are also important for growth and progress towards a functioning market economy.

The close links between real and nominal convergence can, at times, pose policy dilemmas and trade-offs during the accession process. These conflicts are, however, more pertinent at the later stages of accession. High investment and productivity growth required by the real convergence is often associated with higher inflation and current account deficits. In transition countries, differential productivity growth in the traded and non-traded goods sectors (the so-called Balassa-Samuelson effect or BSE) or administrative price adjustments often increase inflation as part of the real convergence process. Also, large inflows of capital to complement domestic savings can help investment, growth, and real convergence, but the resulting monetary expansion, unless sterilized, can challenge competitiveness and inflation targets. At the same time, disinflationary policies to meet the Maastricht inflation criterion can slow growth in the short run and real convergence. However, as the Maastricht criteria become only relevant at the end of the process, the main challenge on the way there is lowering external vulnerabilities and maintaining macroeconomic stability.

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[2] The economic criteria for EU accession have been defined as "existence of a functioning market economy, and the capacity to cope with competitive pressure and market forces within the Union" (two of the five so-called Copenhagen criteria). So far, Bulgaria, Croatia, and Romania have been qualified as functioning market economies. There are no quantitative benchmarks and much of the assessment is based on judgment. Upon membership, the nominal convergence criteria related to joining the monetary union and adoption of the euro are more specifically defined (see Schadler and others, 2005).

In practice, macroeconomic stability and progress with transition are closely interlinked and both are important for sustainable growth and progress towards a functioning market economy. Progress with structural reforms can help macroeconomic stability by, for example, reducing structural external deficits. It also helps nominal convergence, as productivity gains improve competitiveness and help disinflation by keeping unit costs low. Progress with structural transition reforms can, in turn, be easier in a more stable macroeconomic environment. The challenge for the accession process is to achieve both nominal and real convergence with macroeconomic stability and sustainable growth. This can be further complicated by the need to deal with potential shocks such as large and volatile capital flow, and to finalize transition to a market economy. This paper reviews progress with real and nominal convergence in the Southeast European (SEE) countries and the macroeconomic challenges they face in their path towards EU membership.[3]

II. Status of EU Accession in SEE

The various SEE countries are at very different stages of EU accession.[4] While Bulgaria and Romania are close to joining the EU in 2007 or 2008, after five years of negotiations, many others are years behind from even being able to submit a formal application for membership (Table 1). Croatia applied for membership in 2003, and the negotiations started in 2005, once the remaining political criteria related to full cooperation with the International Criminal Tribunal (ICTY) was fulfilled. FYR Macedonia was given applicant status in 2005. Albania has been negotiating an SAA since early 2003, and needs to show progress with both political and economic reforms to advance with these negotiations. The feasibility study for Bosnia concluded in 2003 indicated that more progress was needed with police reform before negotiations for a SAA could start. This was achieved in 2005. The 2005 feasibility study for Serbia and Montenegro gave a green light for SAA negotiations, which were initiated in October 2005 after cooperation with ICTY had sufficiently improved.

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[3] SEE is here defined to include Albania, Bulgaria, Bosnia and Herzegovina, Croatia, FYR Macedonia, Romania, and Serbia and Montenegro. Because Serbia and Montenegro have different monetary regimes, they are at times analyzed as separate economies, although they form a union.

[4] The countries covered are listed in Table 1, ranked in the order of progress with the various accession steps. The process involves a Feasibility Study, which makes a judgment on a country's preparedness to negotiate a Stabilization and Association Agreement (SAA). The SAA includes provisions on trade and other policies to gradually align policies towards EU standards. Membership negotiations are the last phase before accession and involve negotiations on how to adopt EU standards in different policy areas (or chapters).

Table 1. EU Accession Status of the SEE Countries

	Feasibility Study	SAA (Europe Agreement) Negotiation	SAA (Europe Agreement) Conclusion	Application for Membership: Application	Application for Membership: Negotiation Start	Application for Membership: Negotiation End	Accession
Bosnia	2003						
Montenegro	2005	2005					
Serbia	2005	2005					
Albania		2003	ongoing				
FYR Macedonia			2004	2004			
Croatia			2005	2003	2005		
Bulgaria				1995	2000	2004	2007 or 2008
Romania				1995	2000	2004	2007 or 2008

Source: EU website (www.europa.eu.int)

The macroeconomic challenges with EU accession in the SEE differ markedly according to their place on the EU road map and economic situation. Countries in the early stages of accession are still implementing basic transition reforms and are far from establishing functioning market economies. To move from the feasibility study stage to application for membership can take years and seems to be closely correlated with progress in transition. For example, Bosnia, Serbia, and Montenegro, which are most behind with accession, have the lowest score on various transition indicators (Table 1 and Figure 1). For Bulgaria and Romania, these indicators are clearly better after 12–13 years in the accession process, but even they lag behind the recent EU members in Central and Eastern Europe at the moment of their accession in 2004. Criteria related to macroeconomic stability is important at all stages of accession, but the benchmarks are looser than the Maastricht criteria during the early stages of the process. For example, the three most advanced applicants were declared functioning market economies despite still high inflation rates (Romania), current account imbalances (Bulgaria and Romania), or fiscal deficits (Croatia). It follows that the macroeconomic challenges differ substantially between countries at the initial stages of the process and those at the most advanced. The latter need to decide when to join the ERM2 and to meet the Maastricht criteria, which increase the importance of specific macroeconomic targets for macroeconomic policies. [5]

III. Progress in Establishing a Market Economy and Real Convergence

Establishment of a market economy is part of the enabling policy framework that fosters growth. Implicitly, the EU accession criteria is set to foster growth and income convergence by focusing on the establishment of a market economy in the applicant

[5] ERM2 is an arrangement that links the currencies of the prospective members of the monetary union to the Euro by establishing a +/- 15 percent band for exchange rate fluctuations around an agreed central parity.

countries. The related reforms help growth by increasing total factor productivity or by attracting investment. However, transition reforms can impact growth with some lag, as initially output may decline as unprofitable activities are closed or labor made redundant. Growth in transition can also be determined by the quantity and quality of factor inputs like labor and capital, quality of institutions, or external conditions. In a study on the growth experience of the recent EU members, Feldman and Watson (2002) show that growth in the more successful transition countries has reflected more total factor productivity than increases in the relative levels in inputs of capital and labor. This underlines the importance of market-based reforms for growth (see also Falcetti, Lysenko, and Sanfey, 2005). The following focuses on the state of transition reforms in the SEE countries, while other determinants of growth are left for another study.

Various indicators show that most of the SEE countries need substantial progress with transition reforms to become functioning market economies. The EBRD transition index[6] indicates that the three most advanced accession countries are the furthest ahead with these reforms (Figure 1). For many of the other SEE applicants, the index is currently at levels reached by Bulgaria in 1997–98 or the Czech Republic in 1992. The share of the private sector in the economy is also closely correlated with progress with transition reforms. Another indicator of transition, the recovery of output since 1989, also shows that SEE is way behind other European transition countries. While some of this is due to war-related destruction in the 1990s, it also reflects slow implementation of structural reforms in recent years.

If structural reform remains slow, the positive growth rates seen in the last five years in many of the SEE countries may not be sustainable (Figure 2). This would slow down real convergence. The initial reforms—such as trade and price liberalization, (small-scale) privatization in many countries, and relative macroeconomic stability—facilitated growth since 2000 in many countries in the region. Part of the catch up may also be due to a recovery from a low base. But it seems clear that more progress with transition reforms towards a functioning market economy would help sustain growth. The most critical areas for faster reform in the region are further privatization, better investment frameworks, and hardening of budget constraints to improve the savings-investment balances and raise productivity and accountability, further restructure of financial sectors to reduce balance sheet risks, and ensure a sustainable increase in financial intermediation.

Progress with large-scale privatization, in particular, is behind in several SEE countries. This is crucial for productivity and improved the savings-investment balances. While the three countries close to accession have broadly finalized small- and large-scale privatization, much of the region is lagging behind in restructuring their enterprise sectors. This is contributing to macroeconomic imbalances, slower growth, and a sluggish EU

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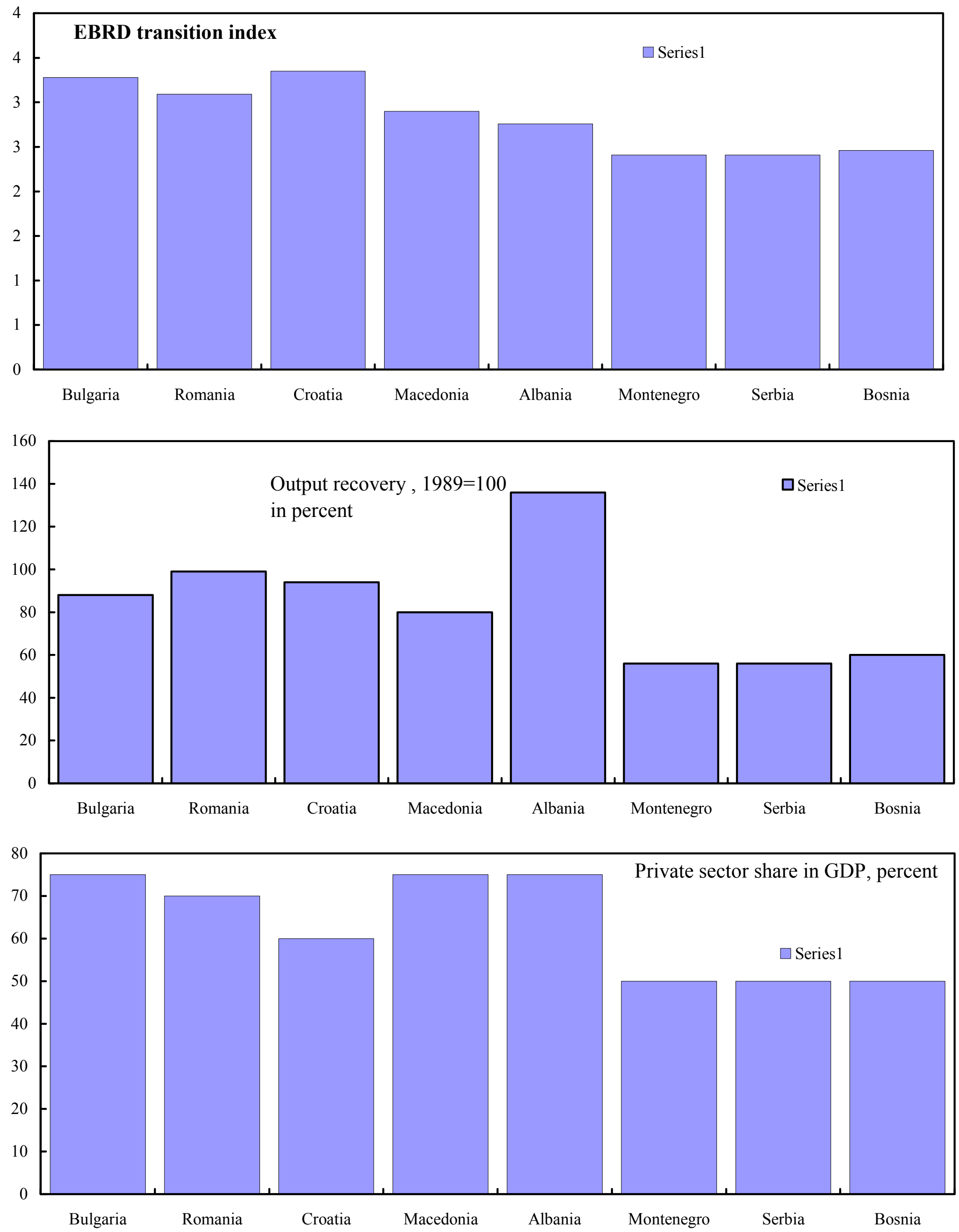
[6] The index measures on a scale from 0 to 4 progress in various structural reforms related to transition to a market economy.

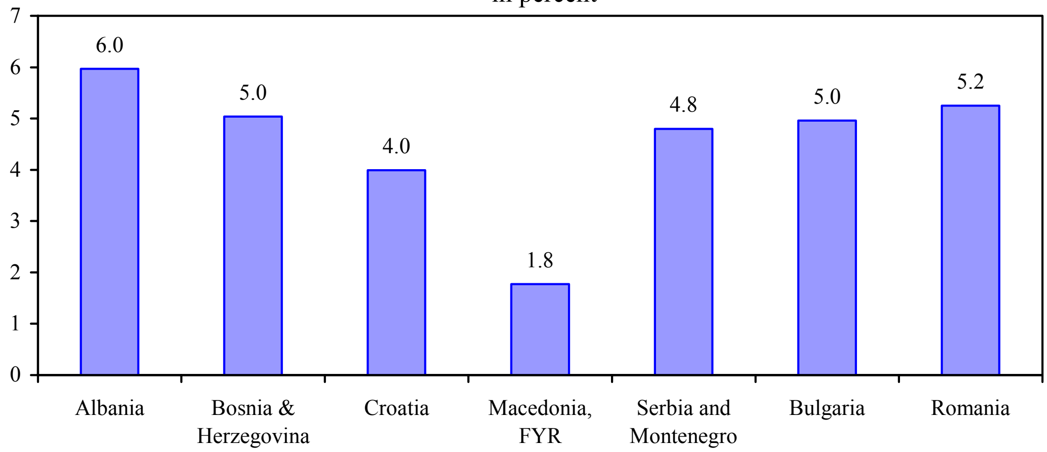
accession process. The small size of the private sector (50-55 percent of GDP), in particular, in Serbia, Montenegro, and Bosnia still in 2004 indicates that too many resources are still trapped in overstaffed and inefficient public enterprises. For example, Serbia has not yet started to seriously restructure and privatized the large state enterprises, including in the energy and telecom sectors, and still hundreds of socially owned loss-making entities are kept afloat with subsidies and arrears. This contributes to negative value-added and dissaving. The related subsidies and arrears are also a drain to public finances and complicate the functioning of private enterprises.

Figure 1. SEE: Indicators of transition in 2004



Source: European Bank for Reconstruction and Development

Figure 2. SEE: GDP Growth, average 2000-05
in percent



Source: World Economic Outlook.

The investment environment in much of the SEE is still burdened with many barriers, which adversely affect investment and growth. Simplifying the framework for business is an important part of a functioning market economy. Although political risk is still high in many countries in the region, improvements in the often cumbersome business environments would lower economic risks. Governance and corruption remain serious problems especially in countries with slow transition, as indicated by their poor scores on the corruption perception index. The establishment of a company also takes about 50 days in some SEE countries. Although they are simplifying processes and establishing one-stop shops for investors, many hurdles remain (Table 2). As a result, the overall competitiveness scores in the late reformers are clearly worse than in the more advanced candidate countries.

Table 2. SEE: Indicators of the Investment Climate, 2004

	Corruption Perception	2005 Competitiveness Index	Business Environment Starting a Business 2005 Number of Procedures	Duration Days	Cumulative FDI per Capita US$ 1989-04	Investment/ GDP/ratio (Percent)
Bulgaria	54	58	11	32	1,050	23.5
Romania	87	67	5	11	746	23
Croatia	67	62	12	49	2,106	33
Macedonia	97	85	13	48	576	25
Albania		100	11	41	450	24
Montenegro	97	80	10	15	491	18
Serbia	97	80	10	15	491	18
Bosnia	82	95	12	54	393	20

Sources: Transparency International; World Competitiveness Report; and World Bank Doing Business Data Base.

The risky overall economic environment and cumbersome business environment partly explain low Foreign Direct Investment (FDI) and investment levels in much of SEE. FDI inflows to the region are still modest, at or below US$500 per capita, reflecting the still high political and economic uncertainties and slow reforms. Croatia has attracted most FDI in per capita terms in the region and has the highest investment to GDP ratio at over 30 percent—close to levels achieved in many of the new EU members. While many countries in the region invest about 20–25 percent of their GDP, Serbia and Montenegro stand out with the lowest ratio at 18 percent of GDP in 2004. FDI has many externalities from transfer of technology and modern business practices and, as such, can foster the establishment of a market economy. Investment needs are large, as the wars destroyed much of the capital stock in the region in the 1990s, and the shift from central planning to market principles made much of the capital stock obsolete.

Reform of financial sectors has advanced in many countries and is increasingly contributing to growth and establishment of a functioning market economy. In most of the region, restructuring and privatization have led to a substantial increase in foreign presence in the banking sector. Nearly all assets are now in private or foreign ownership in Albania, Bosnia, Bulgaria, and Croatia. Romania and Serbia are making progress in this area, but the share of private banks in total assets still remains at about 50-60 percent of total. The privatizations have boosted confidence in banks, which in turn has led to increasing monetization with rapid deposit growth. Together with enhanced access to foreign loans by the new private banks, this has helped fuel a boom in lending in most of the region. The still low credit-to-GDP ratios (ranging from 10 percent in Albania to 60 percent of GDP in Croatia) suggest that the trend will continue as pent-up demand and investment pick up (Table 3).

Table 3. SEE: Financial Sector Indicators in 2004

	M2/GDP/ratio (percent)	Dollarization of Deposits (Percent of Total)	NPLs (Percent of Total Loans)	Credit/GDP/ratio (Percent)	Interest Rate Spreads
Bulgaria	50	48	7.0	37	6.1
Romania	27	41	8.1	17	13.7
Croatia	68	87	4.5	57	10.1
Macedonia	31	50	8.5	24	5.5
Albania	50	30	4.5	10	6.5
Montenegro		100			
Serbia	21	70	23.0	20	11.0
Bosnia	51	50	3.3	45	7

Sources: IMF and EBRD.

The deepening financial intermediation is not without challenges to macroeconomic policy during the accession process. While credit growth no doubt will boost investment and growth, it is also stretching macroeconomic management and banking supervision capacities. In the absence of competitive domestic supplies, much of the credit is used to purchase imports, putting pressure on the external balance. As the bulk of the credit is also in foreign currency, the country's vulnerability to shocks via the exchange rate is increased. This calls for measures to slow down the pace of credit growth. The supervisors are stretched to assess additional risks from potential balance sheet mismatches and to develop relevant prudential rules to lower these risks. So far, nonperforming loans (NPLs) are low in the region, except in Serbia, but the risks increase in line with fast credit growth, as loans are extended to more marginal clients. The high spreads in many countries suggest that more competition would benefit consumers.

IV. Nominal convergence—Monetary and Fiscal Frameworks and Stabilization

While macroeconomic stability is important at all stages of EU accession, its weight grows towards the end of the process as countries upon membership strive to meet the Maastricht criteria. As the economies become more diversified, macroeconomic policies also face new challenges from larger and potentially more volatile capital inflows (Begg and others, 2003) or the need to absorb EU funds in the budget. In this sense, Bulgaria and Romania face different policy challenges in the coming years than the rest of the SEE countries, where macroeconomic stability is still more fragile (Figure 3) and more structural reforms are needed to reduce current imbalances. Bulgaria and Romania need to decide in the next few years when to apply for entry to the ERM2 and adopt the euro and to gear macroeconomic policies towards the attainment of these goals. At the same time, they still struggle with large current account deficits, which complicates stabilization. The other SEE countries need policy frameworks that support more sustainable growth and reduce current vulnerabilities countries. Macroeconomic stability is also an important element of the Regular Reports by the EU on progress with accession and ability to withstand competition in the union. Large imbalances make countries more vulnerable to shocks, which makes it more difficult to survive in a competitive environment.

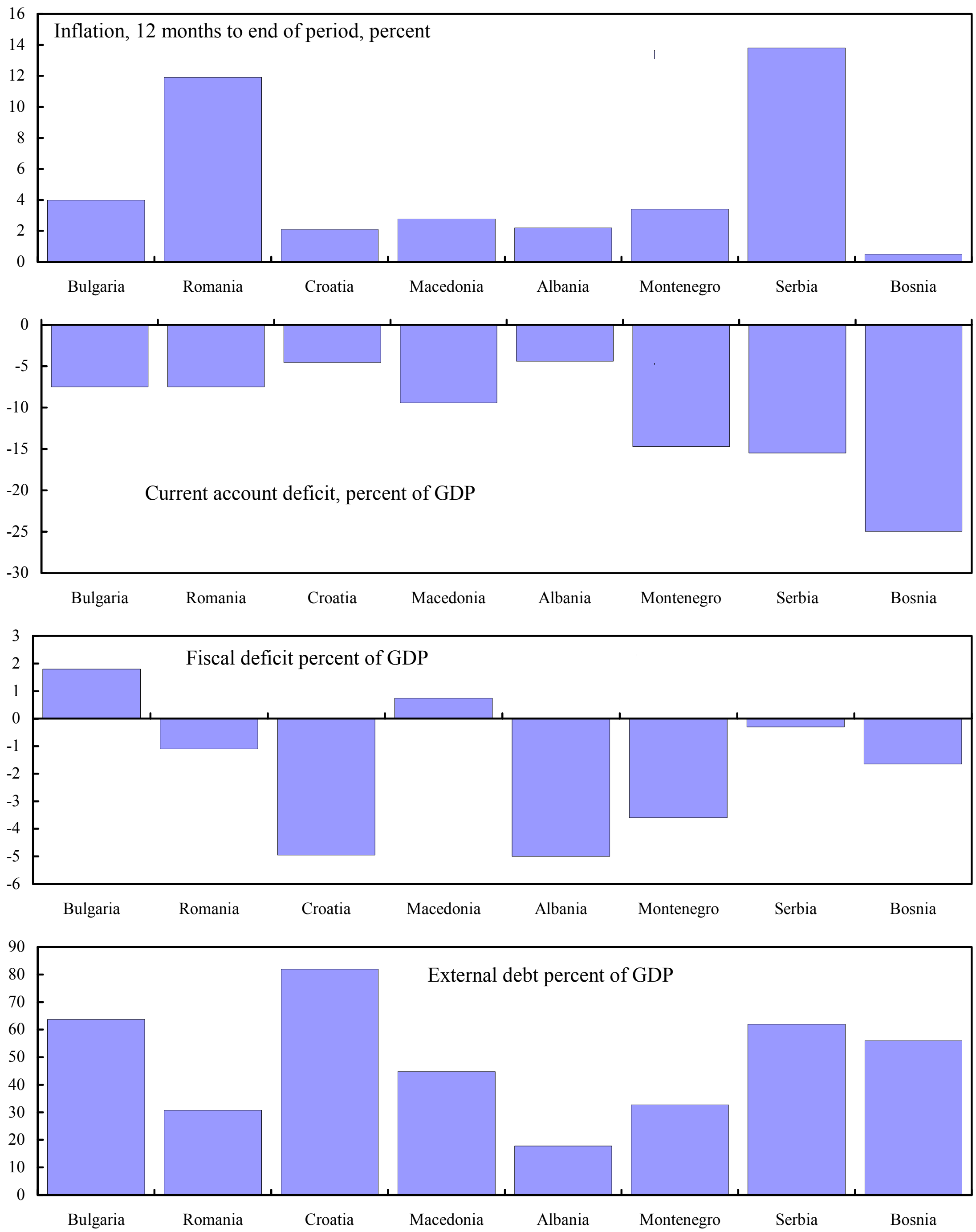
While nominal convergence focuses on achieving certain outcomes for key macroeconomic parameters, there are few accession-related restrictions on the choice of policies to achieve them. For example, the monetary policy frameworks in the recent EU members ranged from currency boards to nearly flexible exchange rate arrangements. Only full formal euroization and currency boards pegged to anchors other than the euro are discouraged by the Economic and Financial Affairs Council (ECOFIN). What matters is the outcome.

Macroeconomic stabilization is also influenced by progress towards real convergence with transition reforms, which underlines complementarities between real and nominal convergence during accession. Progress with real convergence and transition helps nominal convergence, because the effectiveness of fiscal and monetary policies tends to increase when the structural causes of the macroeconomic imbalances are reduced. For example, in Serbia, more progress with transition reforms would reduce the external imbalance by boosting competitive supply for exports and import substitution activities. This would reduce the burden of fiscal and monetary policies in stabilization and increase their effectiveness. In this sense, progress towards a functioning market economy, as required by the accession process, makes the achievement of subsequent nominal convergence easier. The following explores how macroeconomic policies, in particular monetary and fiscal policies, in the SEE countries have contributed to stabilization outcomes.

A. Stabilization and Monetary Policy Frameworks

Like many countries in the early phases of transition, the SEE countries have relied mainly on exchange rate anchors to lower inflation. Apart from Albania, Romania, and Serbia, all other SEE countries have had either a currency board or a tightly managed float or peg for some time (Table 4). In most of these countries, the exchange rate anchors helped reduce inflation to low single digits by 2004. Albania's managed float and informal inflation targeting were also successful in keeping inflation low, while in Romania, inflation, although declining under the managed float, remains close to double digits. Since 2000 Serbia has shifted between nominal and close to real exchange rate targeting (with important regime shifts in early 2003 and 2005). Inflation first declined with the exchange rate anchor, but an increasing external deficit prompted a shift to a managed float in 2003. However, inflation resurged, as suppressed administrative prices were readjusted and growing euroization contributed to an increased pass-through from the exchange rate to prices. The regime shifts may also have adversely affected monetary policy credibility, as indicated by the growing euroization.

Figure 3. SEE: Macroeconomic indicators, 2004



Source: IMF staff estimates.

Table 4. SEE: Summary of Monetary Policy Frameworks

Country	Exchange Rate Regime	Monetary Policy Framework	Capital Controls
Albania	Loosely managed float, Euro reference currency	Informal inflation targeting via money growth targeting	**Moderate**. Controls on outflows, licensing, and monitoring requirements for many other flows
Bosnia	Currency board with Euro peg	Exchange rate anchor	**Low.**
Croatia	Tightly managed float, Euro reference currency	Exchange rate anchor	**Moderate.** Limits on inward portfolio investment, controls on outflows by individuals to non-OECD countries, bonds purchased by non-residents must be held for a year, they cannot buy central bank or treasury bills, or short-term money markets instruments. Must be held until maturity, minimum rating requirements for non-resident issuers locally, restrictions on ST loans to foreigners, limits on investment fund placements abroad
Macedonia	De facto peg to Euro	Nominal exchange rate anchor	**Moderate**. Limits on share purchases by foreigners, on security purchases and issuance abroad, administrative barriers to short-term inflows.
Montenegro	Euro	Exchange rate anchor	**Low.**
Serbia	Tightly managed float	Exchange rate anchor	**Moderate.** Non residents cannot buy local money market instruments, or short-term securities, outflow restrictions on security purchases abroad, controls on certain types of borrowing from abroad, and real estate purchases abroad, non-residents cannot borrow in dinars.
Bulgaria	Currency board	Exchange rate anchor	**Low.**
Romania	Managed float, reference Euro	Flexible inflation targeting	**Low.** Some controls on real estate transactions, non-resident purchases of ST government paper until 2006, most other capital transactions liberalized.

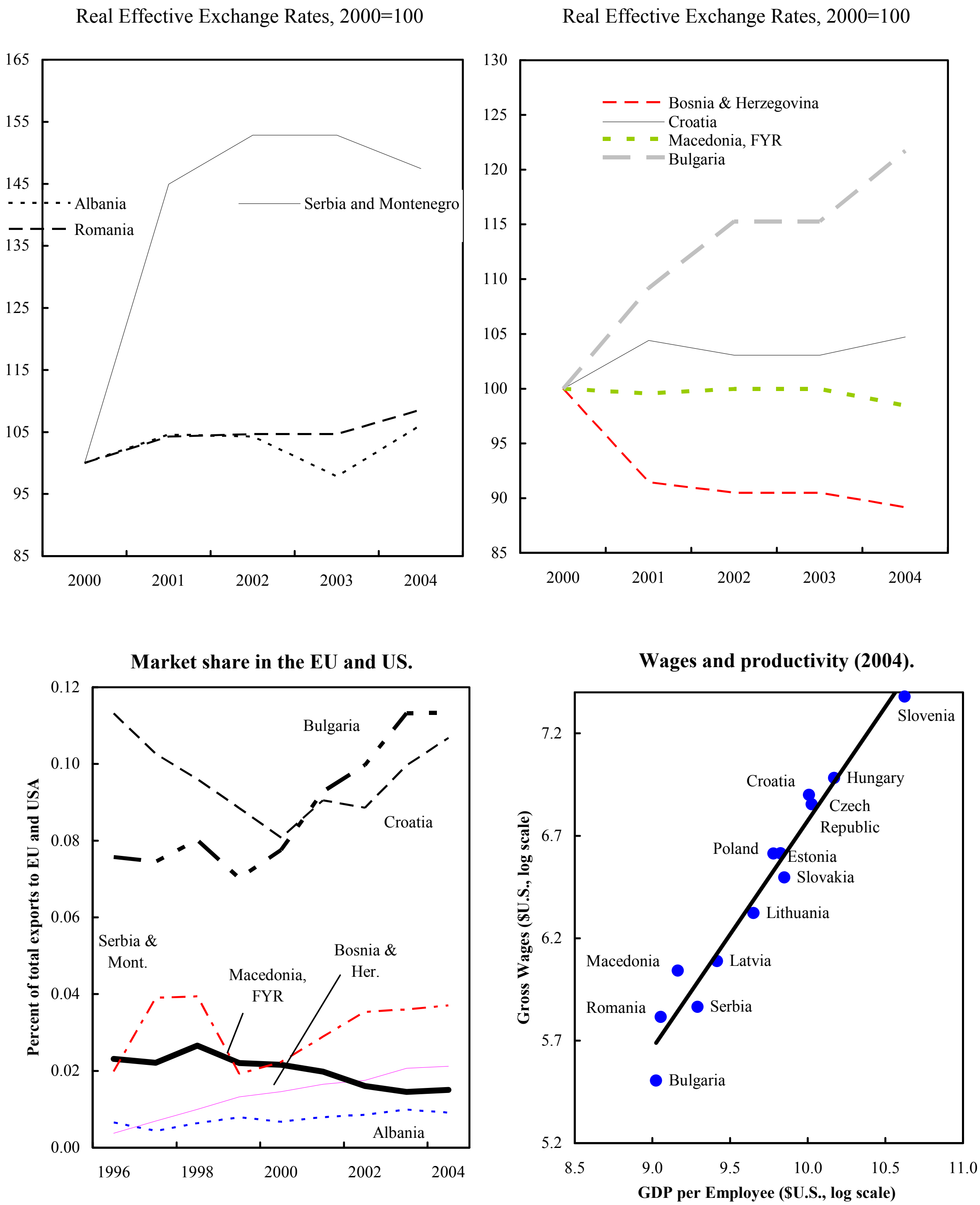
Source: IMF: Annual Reports on Exchange Rate Arrangements and Exchange Restrictions.

The anchors have been less successful in lowering external imbalances suggesting trade-offs with inflation. Although large fiscal deficits may have contributed to external imbalances in some countries (Croatia), they also reflect slow progress in reforming the real economy. Incidentally, the largest current account deficits are in countries with least progress with structural reforms (Serbia, Montenegro, Bosnia, and potentially Macedonia) measured either by transition indicators or the share of private sector in GDP. This confirms that nominal convergence and macroeconomic stability are closely linked to real convergence and the introduction of a market economy. The large imbalances increase macroeconomic vulnerability, which is exacerbated by the high external debt levels in many of these countries (see Figure 3). The high debt levels also constrain future reliance on foreign savings to finance investment with a potential impact on the speed of real convergence.

The exchange rate anchors and sluggish structural reform put pressure on competitiveness. Fixed or nearly fixed exchange rates can lead to unsustainable real appreciation and loss of competitiveness, unless fiscal and incomes policies remain tight and structural reforms boost productivity. For example, in Serbia, the exchange rate anchor in 2002 became unsustainable as large real wage increases and slow structural reforms eroded competitiveness and increased the external deficit. Pressures for real appreciation in the region also arise from the large inflows of foreign currency. Remittances are around 10–20 percent of GDP, and FDI and private foreign borrowing have increased in recent years in some countries. This makes faster structural reforms and tight demand management even more important to maintain competitiveness.

Available indicators show, at most, a mixed picture of competitiveness in the region. Wage and productivity data for 2004, which is subject to many measurement problems, point to potential competitiveness problems in Croatia and Macedonia. The evolution of EU export market shares also suggests that Macedonia may have lost competitiveness, while most others have increased their share in the EU market. The real effective exchange rates data (REER) show a large appreciation in Bulgaria, Romania, and Albania in recent years, which at least in the former two is likely to reflect changes in market fundamentals in terms of increased productivity. In the remainder of the SEE, there is no clear trend with real appreciation and the REERs have remained relatively flat in the past few years. The serious data problems make it difficult to draw firmer conclusions on this.

Figure 4. SEE: Competiveness Indicators, 2000-04



Sources: Information Systems (INS); and IMF staff estimates.

The SEE can draw on the experience of the recent new EU members with monetary framework during accession. The exchange rate regimes during accession have varied widely, which points to the importance of fundamentals and accompanying policies in achieving macroeconomic stability. Some of the larger recent EU members gradually moved from exchange-rate-based stabilizations to more flexible monetary policy frameworks as transition advanced. A similar trend is observed in several other emerging market countries, perhaps influenced by the lessons from emerging market crises of the 1990s with exchange rate anchors. Those in Asia or Russia were linked to mobile capital in broadly fixed exchange rate settings, which eventually became unsustainable as fundamentals changed and competitiveness was lost. A currency crisis often led to financial crisis as banks were exposed to large currency or maturity risks and felt the effects of slower growth. The crises also exposed many vulnerabilities of these arrangements to moral hazard, when markets took the exchange rate parity as given and ignored exchange rate risks. More flexible monetary policy frameworks can help absorb shocks with the exchange rate or by conducting an independent monetary policy. This may be something the SEE countries, in particular Croatia and Serbia, may want to consider over time.

At the same time, several of the smaller recent EU members have successfully maintained currency boards throughout transition. These helped anchor inflation expectations, lower interest rates by gradually reducing foreign exchange risk, and increase the predictability of monetary policy. Sustainability was achieved by progress with structural reform that boosted productivity and prudent fiscal policies that contained demand pressures. Financial sector reform and strong supervision reduced financial sector vulnerabilities. For example, the Baltic countries with currency boards withstood the 1998 Russian crisis well despite a sharp decline in output. The maintenance of prudent fiscal policies and continued implementation of structural reforms led to a rapid recovery.

The sustainability of the exchange rate anchors in SEE will crucially depend on the accompanying policies. So far, the slow progress with structural reform in many of these economies increases the risks associated with soft pegs. Competitiveness may also be eroded over time, either with a lack of fiscal discipline or weak incomes policies. Given lagging structural reforms, Bosnia with a currency board and Montenegro with the euro may need to tighten fiscal and incomes policies further to ensure that competitiveness is maintained and that their current accounts become more sustainable. In Serbia and Macedonia, where fiscal policy has been tight, the exchange rate anchor may become problematic if competitiveness is lost. This can happen if incomes policies are loosened or structural reforms fail to boost productivity. Croatia, which has significant fiscal deficits and an exchange rate anchor, may also be facing problems with competitiveness over time. This can be triggered if currency inflows to the tourism sector or strong capital inflows lead to real appreciation, with adverse consequences for other traded goods sectors. However, Croatia current account deficit declined in 2003 and 2004.

Any moves to more flexible arrangements in SEE need to be carefully considered to avoid market disruptions. Currently, the high share of euroization, especially in Serbia and Croatia (70 percent and 87 percent of deposits, respectively), complicates any potential shift to a more flexible monetary policy framework. The resulting weak interest rate transmission mechanism reduces the potential for monetary policy to lower inflation. The scope for an independent monetary policy in small open economies can also be limited when the capital account is further liberalized. Furthermore, the shallow and underdeveloped financial markets in many of these countries can lead to large exchange rate volatility with more flexible exchange rate arrangements. This further complicates stabilization.

At the same time, the risk for speculative attacks on most of the SEE currencies can be limited by their underdeveloped capital markets and by the maintenance of capital controls, especially for short-term assets (Table 4). Apart from the foreign exchange market, there are very few instruments that foreign portfolio investors can buy, and access to government paper is limited to residents in all of the countries. The foreign banks can also import capital and invest it in domestic markets, but so far the boom in lending seems to carry much higher returns than potential speculation with the currency. Their large foreign currency exposures in lending may also reduce their interest in destabilizing the currency. However, as financial markets develop, this is likely to change.

In Bulgaria and Romania, one of the medium-term macroeconomic challenges related to the monetary frameworks is to decide when to adopt the euro. This requires countries to participate in the ERM2 for two years and meeting the set Maastricht criteria:[6]

- Inflation – lowest 3 EU members plus 1.5 percent during one year
- Fiscal deficit – below 3 percent of GDP
- Public debt – below 60 percent of GDP
- Long-term interest rates – below average of the three low inflation countries plus 2 percent
- Exchange rates – within the EMS band (+/- 15 percent) for 2 years with stability around the central rate

Bulgaria may currently be closer to meeting the Maastricht criteria than Romania, but both need to ensure that they can deal with various shocks before entering ERM2. Both countries meet the Maastricht fiscal targets, but especially Romania is a long way from fulfilling the inflation target.[7] The stability of the currency board and the relatively low inflation in recent years are likely to make it easier for Bulgaria to enter the ERM2 than for Romania, which needs to further stabilize its economy. However, both need to be ready to deal with high and potentially volatile capital inflows or larger external shocks, which may test the maintenance of the indicators at their current levels. For example, Romania's official

[6] The criteria are subject to some interpretation. For example, if the fiscal deficit and debt are declining towards the required levels, there may be some room for interpretation in, for example, allowing a higher deficit. In practice, the exchange rate criterion has been more strictly interpreted than the official limits. Appreciation and upward adjustments in parities are tolerated more easily than downward adjustments of the rate. Statements by the Economic and Financial Committee (EFC) suggest that stability is interpreted to require movements within a +/- 2.25 percent band instead of the allowed maximum fluctuation of +/- 15 percent (for a discussion, see Schadler and others, 2005).

[7] The ECB Convergence report for 2004 calculated the reference inflation rate as 2.4 percent and interest rate 6.4 percent.

shift in August 2005 to an inflation targeting framework and further opening up of its capital account led to important speculative capital inflows. These complicated monetary management, and forced the central bank to intervene in the foreign exchange market to avoid excessive real appreciation and potential problems with competitiveness. Dealing with these shocks may require further flexibility from fiscal policy, continued strengthening of the financial sector, and prudence with monetary management.

The disinflation path can also be complicated by real appreciation stemming from the real convergence process. Inflation can be generated by a faster productivity growth in the tradables versus the nontradables sector. Estimates of this Balassa-Samuelson effect vary widely for different transition countries and have ranged around 0.2–2 percent per annum on average in the recent EU members (Mihaljek and Klau 2004). Together with a potential further need to adjust administrative prices, this is likely to result in inflation being much above that required by the Maastricht criteria for some time. But as the BS effect is an equilibrium phenomena related to changes in fundamentals, it should be allowed to take place and not suppressed by tighter demand management policies. Nor should competitiveness be threatened, provided the source of price changes is properly identified. This underlines the importance of close monitoring and analysis of the movements of the REER in the convergence process. This can also imply that entry into ERM2 may not be desirable until basic transition reforms are more advanced.

B. Fiscal Policy Challenges

Fiscal policy can support both nominal and real convergence in accession countries. In particular with exchange rate anchors, fiscal policy needs to be flexible enough to deal with potential external and internal shocks to ensure external balance and low inflation. At the same time, fiscal policy can support real convergence and sustainable growth. The specific medium-term fiscal challenges depend on the economic situation of various countries and their stage of accession. Most are still far from needing to meet the Maastricht criteria, and, apart from perhaps Romania and Bulgaria, do not need to worry about this in the near term. The following fiscal issues stand out in the SEE countries:

- **Regardless of the monetary policy frameworks or stage in accession, stronger fiscal positions in some of the SEE countries can contribute to growth.** This would release resources from the public to the private sector. The details of the needed fiscal stance can depend on country vulnerabilities, inflationary pressures, particular shocks, or challenges of aging.

- **Lowering of the still high tax burden, in particular on labor, should also contribute to growth**. Lower taxes would promote private employment creation and reduce the informal sector.

- **Expenditures need substantial rationalization to meet spending pressures to support growth and reforms and lower the size of the state in the economy.** All countries (except Romania) face the problem of rigid expenditure structures that limit the potential to lower taxes and increase pro-growth spending. Cuts in current spending are needed to give room for transition-related spending, including on safety nets, infrastructure, environment, or, eventually, on adopting the "acquis" of the EU (Bulgaria and Romania in the near future).

- **The challenge in Romania is to raise more revenues to provide room for further fiscal consolidation needed to deal with the current account deficit and EU-related expenditures.** The current low revenue-to-GDP ratio (29 percent of GDP) makes it difficult to provide basic services and a safety net to citizens. Therefore, raising more revenue is a key fiscal policy issue.

Stronger fiscal positions in many of the SEE countries would support growth and stabilization. Some have relatively large deficits of around 2–5 percent of GDP (Albania, Croatia, to some extent Bosnia, and Montenegro).[8] This is often accompanied with high levels of public debt, which increases their vulnerability to shocks (Table 5). Although many of these countries have relatively modest inflation rates by regional standards, some have substantial external deficits increasing further their macroeconomic vulnerability. With monetary policy limited by the exchange rate anchors and high euroization, a tighter fiscal stance could help reduce external imbalances and improve their ability to respond to shocks. In Serbia and Macedonia, the fiscal surpluses have, so far, only marginally lowered the large external imbalances, which may reflect large quasi-fiscal activities and dissaving in the non-reformed public enterprise sector. This points to another important link between nominal and real convergence--unless structural reforms advance, public saving may need to increase further to reduce external vulnerabilities. To better assess medium-term fiscal challenges, it would be useful to calculate sustainable fiscal positions with various assumptions about the behavior of private savings, current account deficits, and debt levels.

Table 5. SEE: Main Fiscal Indicators, 2004
(In percent of GDP)

	Overall Deficit	Expenditures	Wage Bill	Transfers	Nondiscretionary Spending	Capital Spending	Public Debt
Bulgaria	1.7	40	5	17	53	3.9	39
Romania	-1.1	31	5	12	59	3.3	24
Croatia	-4.9	52	12	22	66	5.1	54
Macedonia	0.7	37	9	19	76	3.2	41
Albania	-5.3	29	7	8	51	3.1	55
Montenegro	-3.1	38	10	17	72	2.0	48
Serbia	0.0	46	10	21	67	2.6	60
Bosnia	-1.6	49	n.a.	18	n.a.	6.2	30

Sources: Various IMF staff reports.

[8] The definition of public sector can vary across countries (e.g., inclusion of municipalities), making this data only broadly comparable across countries.

The flexibility of fiscal policy in much of the SEE countries could be improved by lowering the high share of nondiscretionary expenditures in total and the high level of public spending. This calls for expenditure reforms. The share of public expenditure in GDP ranges from a low 30 percent in Albania and Romania to over 50 percent in Bosnia and Croatia. Most countries in the region have expenditure levels well above the average of 40 percent of the recent EU members (or CEE5)[9]. Nondiscretionary spending accounts for 60–75 percent or more of total expenditures in all but Albania and Bulgaria, which limits fiscal policy flexibility. Public sector wage bills (close to 10 percent of GDP) and transfers (close to 20 percent of GDP) are particularly large in most of the SEE countries, except Bulgaria and Romania, reflecting still generous and often unreformed social security systems that the countries cannot afford.

Reforms aiming at pension systems, civil service restructuring, and state enterprise reform should reduce the size of the public sector and create room for pro-growth spending such as investment. Public investment spending in many of the SEE countries is only about 2–3 percent of GDP, which is low compared to the 4–5 percent of GDP in the three more advanced EU accession countries. Many of the needed expenditure reforms are closely related to further structural reforms or advances in transition. The aging of populations and restructuring- and EU-related expenditures will present other challenges for improving the structure of spending in these countries. It is also important to have well-targeted safety nets to assist those adversely affected by the transition.

The efficiency of the tax system has been improving recently with a shift towards indirect taxes (Table 6). All countries have introduced the value-added tax (VAT) (Bosnia in January 2006), which has helped increase the share of direct taxes in total, which now amount to 40–50 percent of total tax collection. However, a further shift towards indirect taxes would increase savings. Both corporate and personal income taxes have already been reduced in many of the SEE countries to the lowest levels in Europe, which limits the potential to cut these further. On the other hand, labor taxation in SEE is relatively high, ranging from 35 to 50 percent of wages. Further reductions would help job creation and reduce the size of the informal sector. Revenue administration reforms would also boost productivity of various taxes in the region. Other countries could follow the example of Bulgaria and Romania to unify the collection of various social security contributions, or in the longer run, to merge it further with collection of all taxes.

The Stabilization and Association Agreements are also likely to imply changes in the tariff structures and excises in many of the SEE countries. The SAA is a first step towards aligning the external tariffs towards EU levels. As most SEE countries are likely to have higher overall levels of protection than the EU, the resulting liberalization would boost competition, but lower collection from trade taxes. Another challenge for tax policy will be the adoption of the required EU levels of excises on alcoholic beverages, tobacco, energy, and electricity (see FAD, 2005). This in most cases will imply increases in these taxes in the

[9] Czech Republic, Hungary, Poland, Slovak Republic, and Slovenia

SEE countries and more revenues from this source. In some countries, the gradual decline in grants also poses a challenge for revenue collection.

To meet these various challenges, the SEE countries should develop more detailed fiscal strategies with clear medium-term priorities. This implies the development of medium-term macroeconomic and fiscal frameworks in line with the macroeconomic situation of the countries and their policy priorities. This would lead to the identification of a sustainable fiscal path. The next step is to find reforms that are needed to achieve the desired path. In many countries, fiscal transparency also needs to be reinforced. As accession advances, these issues will need to be incorporated in the countries' Pre-Accession Economic Programs, which Bulgaria, Croatia, and Romania have already prepared for some years, and which the other countries will need to prepare as accession draws nearer.

Table 6. Selected Statutory Tax Rates—New EU Members and SEE Candidate Countries, 2004
(In percent)

	VAT Rates	Corporate Tax	Personal Income Tax Rates		Social Security		
	Standard, Reduced	Top Marginal	Top Marginal	Number of Tax Brackets	Employer	Employee	Total
CEEC5							
Czech Republic	19, 5	28	32	4	35	12.5	47.5
Hungary	25, 15, 5	16	40	3	29	11.5	40.5
Poland 1/	22, 7, 3	19	32.25	3	19.8-22.7	26.7	
Slovenia	20, 8.5	25	50	6	16.1	22.1	38.2
Slovak Republic	19	19	19	1	35.2	13.4	48.6
Candidate Countries							
Bulgaria	20	19.5	29	4	14	24	38
Croatia	22	20.32	25	2	17.8	17.8	35.6
Romania	19, 9	16	16	3	32.5	17	49.5
Albania	20	23	30	5	30.7	11.2	41.9
Bosnia							
Macedonia	18, 5	15	24	3			
Montenegro	17, 8	9	23		20-42	18	38-60
Serbia 2/ 3/	18, 8	10	14	2	17.9	17.9	35.8

Sources: OECD; and national sources from FAD (2005).

1/ The official top marginal rate of personal income taxes is 40 percent and was adjusted for tax deductible healthcare contributions which are classified as social contributions.

2/ Under personal income tax rates, top marginal column: wages and salaries, income from agriculture and forestry and income from self-employment are taxed at 14 percent. However, revenue stemming from other sources such as copyrights and property rights, yield on capital, revenue real estate, capital gain, income from leasing equipment, games-of-chance winnings, from personal insurance and some others are taxed at 20 percent (while dividends are taxed at 20 percent, 50 percent of gross dividends and other revenues stemming from the share of profits are exempt, so the rate on dividends is effectively 10 percent.).

3/Under personal income tax rates, number of tax brackets column: if the realized annual income from the sources listed in 2/ exceeds a certain threshold (adjusted every year by the wage growth), the amount in excess of this threshold is taxed at 10 percent.

V. Conclusions

Most of the SEE countries are still years away from EU accession and need substantial progress in establishing functioning market economies and solidifying macroeconomic stability. While further structural reform is also important for Bulgaria, Croatia, and Romania, it is essential for the remainder of the SEE countries to progress with EU accession. Various indicators show that the economies of Albania, Bosnia, Macedonia, and Serbia and Montenegro need more progress with transition reforms to become functioning market economies, which is the key yardstick used by the EU to move countries from one stage of accession to another. The slow structural reform is also reflected in low levels of FDI, and may limit growth potential in the medium-term—or real convergence. Sluggish structural reform is also affecting macroeconomic stability, which is at the core of large external imbalances in some countries. Especially in Bosnia and Serbia, large current account deficits reflect a low level of competitive exports, while imports are being boosted by large remittances, strong credit growth, or potentially lax demand management.

While macroeconomic stability is essential throughout the process, its importance increases in the last stage of accession when countries upon membership face decisions to apply for entry into the ERM2 and the Maastricht criteria. In the two most advanced countries in the process, Bulgaria and Romania, despite years of reform and relative macroeconomic stability, many challenges remain before they can meet these criteria. This suggests that they may need quite a few years before being ready to enter the monetary union. Both countries still have large external imbalances and inflation well above that implied by the Maastricht criteria, and their economies may also be vulnerable to external shocks such as large inflows of capital. They may also still face important adjustments to administered prices or price pressures from the BS effect that complicate inflation dynamics and demand management. Much of these reflect equilibrium phenomena, and the challenge is also to identify with these processes and unsustainable imbalances or other sources of inflation. Bulgaria, with a currency board, may be closer to meeting the relevant conditions for monetary union membership than Romania, where inflation is still close to double digits.

The macroeconomic challenges in the other SEE countries are related to sustainability of their monetary frameworks, risks from rapid financial deepening, and further fiscal consolidation to support growth and stabilization. Many of the current exchange rate anchors may not be sustainable over time, unless they are better supported by fiscal consolidation and structural reforms. Although various indicators show no clear signs of problems with competitiveness in these countries now, the large external deficits and weak supporting policies in some countries can increase these risks over time. However, a shift to more flexible monetary frameworks is complicated by high euroization, which has resulted in weak monetary policy transmission mechanisms. This further underlines the need for fiscal consolidation and increasing the flexibility of fiscal policy to respond to shocks and the need for structural reform to lower external imbalances. Rapid credit growth, especially in foreign currency, is putting additional pressure on the external balance and inflation dynamics in many countries and is challenging supervisory capacities to mitigate risks in the financial sector.

Most of the SEE countries have room to lower public spending and increase the share of pro-growth spending. Lower deficits would boost private-sector-led growth and facilitate macroeconomic management. Growth would also be boosted by lowering the still high labor taxes in many countries. However, the main thrust of fiscal adjustment should come from reducing the large public sector wage bills, subsidies, and transfers. This calls for civil service, pension, and health care reforms and for enterprise restructuring to lower subsidies.

While this paper is only a brief overview of the macroeconomic issues with EU accession, more detailed work would be needed to assess the challenges in more depth. Further work, in particular on competitiveness, monetary policy transmission and effectiveness, inflation dynamics, and sources and determinants of growth and productivity, would be useful.

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