

CHAPTER 1

Motivation and Macroeconomic Context

Motivation for the Study

Many countries in SEE5 have witnessed significant growth since the mid-1990s.¹ With the exception of FYR Macedonia, all other countries of SEE5 witnessed annual growth rates over the last decade in excess of 5 percent, and even FYR Macedonia has seen acceleration in its growth rates since 2003 (see table 1.1). The growth performance of UNMIK (United Nations Interim Administration Mission in Kosovo)/Kosovo and Montenegro, considered separately from Serbia, has been mixed (see table 1.2). Montenegro's growth has accelerated since 2002 and is estimated at 6.5 percent in 2006. UNMIK/Kosovo's growth was estimated at 3 percent in 2006, which was lower than in previous years. Moreover, while growth rates have been significant in some cases, they fall short of the highest growth rates in the region. Even the growth rate of Albania, the top performer in SEE5 since 2000, falls short of the 7 to 8 percent growth rate of the Baltic countries. The other three SEE countries have seen steadier growth that has not fallen below 4 percent in the last five years. Growth in Romania and Bulgaria has accelerated to an average of around 5.5 to 6 percent between 2004 and 2006.

However, SEE is now faced with the challenge of improving upon and sustaining this growth performance. Growth accounting shows that

Table 1.1. Key Economic and Social Indicators, SEE and Slovakia

	<i>Albania</i>	<i>Bosnia and Herzegovina</i>	<i>Bulgaria</i>	<i>Croatia</i>	<i>FYRM</i>	<i>Romania</i>	<i>Serbia and Montenegro</i>	<i>Slovak Republic</i>	<i>SEE5</i>	<i>SEE</i>
GDP growth average (1996–2006)	5.0	9.2	3.6	3.9	2.4	2.5	2.2	4.5	4.19	3.37
GDP growth average (2000–06)	5.3	5.1	5.1	4.7	1.7	6.0	5.1	5.4	4.74	5.34
Fiscal balance (% GDP, 2005)	–3.6	0.8	3.2	–3.9	0.2	–0.8	0.9	–3.1	–0.4	–0.7
Fiscal balance (% GDP, 2006)	–3.2	2.6	3.4	–3.1	–0.6	–1.7	–1.5	–3.5	–0.7	–0.6
CAB (% GDP, 2006)	–7.2	–11.6	–15.8	–7.4	–0.4	–10.5	–11.3	–8.5	–7.6	–9.2
FDI (% GDP, 2006)	3.7	4.6	12.7	7.8	5.6	9.8	—	6.9	4.7	7.4
Gross domestic investment (% GDP, 2006)	25.3	20.3	31.9	29.8	22.1	24.7	21.5	29.0	22.3	25.1
GDP per capita 2006 (current US\$)	2,825	2,924	4,089	9,646	3,052	5,579	4,220	10,219	3,514	5,011
Government expenditure (% GDP, 2005)	27.8	48.6	38.3	48.8	35.3	31.1	—	38.0	37.2	38.3
External debt (% GDP, 2006)	20.8	52.2	80.4	89	38.4	32.4	62.1	56.6	43.4	53.6
Exports of goods and nonfactor services (% GDP, 2005)	21.8	36.2	60.8	47.1	45.1	33.0	26.9	78.7	32.5	38.7
Exports of goods and nonfactor services (% GDP, 2000–05)	14.2	28.0	52.8	42.9	40.0	29.0	22.9	62.7	26.3	32.8
Merchandise exports (% GDP, 2005)	7.9	24.1	44.0	22.9	35.4	28.1	19.3	68.9	21.7	26.0

Merchandise exports (% GDP, 2000–05)	7.7	19.5	39.2	22.6	32.7	29.2	16.6	63.5	19.1	23.9
Sovereign rating (S&P) 05/2007	—	—	BBB+	BBB	BB+	BBB–	BB–	A	—	—
Sovereign rating (Moody's) 05/2008	—	B2	Baa3	Baa3	—	Baa3	—	A1	—	—
Transparency International Corruption Perception Rank (2006)	111	93	57	69	105	84	90	—	—	—
Worker remittances (net, % of GDP, 2005)	13.86	13.50	3.78	2.23	3.18	3.81	—	—	10.2	6.7
Worker remittances (received, % of GDP, 2005)	13.86	13.22	3.78	2.17	2.94	3.81	—	—	10.0	6.6
Labor force participation Rate 2005 or 2006 (%)	64.7	74.4	64.5	64.2	60.6	63.6	65.5	69.4	66.3	65.4
Unemployment rate (% , 2004 or latest year available)	15.2	42	12.1	12.7	37.2	8	15.2	18.1	—	—

Source: World Bank World Development Indicators database; national authorities.

Notes: The IMF Staff Report for 2006 for FYR Macedonia puts private transfers at 17.7 percent of GDP in 2005. Growth averages and GDP per capita for country groups are population weighted. The rest of the indicators are simple average of the respective country group averages (SEE5 and SEE). Sovereign rating refers to long-term foreign currency debt. Participation rates data is drawn from ILO, Eurostat, and the World Bank. Serbia and Montenegro refers to Serbia and Montenegro prior to 2006 and to Serbia only for 2006. All data for Serbia excludes Kosovo. Unemployment rate for Bosnia and Herzegovina includes voluntary unemployment as well.
— = not available.

this may become more difficult. Given their still significant poverty levels and their EU aspirations, SEE countries need to improve upon and sustain their growth performance. Growth accounting shows that this may become harder than in the past. Post-transition, the simple reallocation of resources may explain most of the increases in total factor productivity (TFP), which can in turn be the driver of growth. However, this source of TFP growth can run its course over time, and would require harder reforms to enable within-sector TFP growth. A regional study of Europe and Central Asia finds a decline in TFP growth from more than 4 percent during 1995–98 to 2 percent during 1999–2005 for SEE as a whole.² Because the share of the public sector in Serbia and Bosnia and Herzegovina is still large, there is still significant room for reallocation-based TFP growth, but the opportunities for this kind of growth may reduce over time. This can be seen, for example, in the dominant contribution of within-sector productivity growth to labor productivity growth in the EU10 over 1999–2004. For SEE, on the other hand, the between-sector component was still important. For the CIS countries, labor productivity growth was dominated by the between-sector component as well. With development, therefore, it can be expected that the within-sector gains will dominate, but these are not achieved automatically.

Sustainable future growth must now be more export-led than in the past. This will, in turn, create demand for improvements in TFP. Small countries gain more than larger ones from trade-induced expansion in market size, which makes the effect of trade on per capita income and rate of growth on small countries much larger (Helpman 2004). In the Balkans, there is little doubt that the key response to the challenges of improving and sustaining growth would involve a sustained increase in exports, given small-country size and the experience of the EU8 countries. Unfortunately, exports have not played a compelling role in the SEE5 growth story, and exports, especially merchandise exports, are in fact the weak link, despite the EU's extension of trade preferences. Per capita exports of both goods and services are much lower than comparators, notwithstanding the recent improvement in export growth, and the region has been undertrading relative to its potential.

Greater trade integration with the EU also demands increased exports. To the extent that there are still some restrictions on imports into SEE5, the ongoing process of EU integration, as represented, for example, by the Stabilization and Association Agreements (SAAs),

would lead to a lowering of barriers and an increase in imports. External sustainability would then require a concomitant increase in exports. The bottom line is that exports have to increase, both for reasons of growth and to keep pace with the likely increase in integration-driven imports. This will not occur automatically and will need concerted policy actions on several fronts.

At the same time, the export imperative must confront the reality of erosion in trade preferences for SEE5, which is caused by Bulgarian and Romanian EU accession, other preferential trade agreements negotiated by the EU, and the progress of multilateral trade liberalization. In 2004, EU enlargement brought 10 countries with 75 million inhabitants into the Single Market. In January 2007, the accession of Bulgaria and Romania brought in two SEE countries with a joint population of 30 million. This reduces the relative attractiveness of SEE5 countries as trading partners and as a destination for FDI, because they are not yet a part of a pan-European cumulation of rules of origin (although this is in process for countries that have signed SAAs). Moreover, the EU has concluded many free/bilateral trade agreements with countries around the world, such as Chile, Mexico, South Africa, and the Mediterranean, to name a few. Multilateral liberalization is also providing better access to Asia, such as in apparel and textiles. Indeed, stronger competition from China and other Asian countries is already felt in such products.

Persistently-high current account deficits (CADs) also raise concerns about macroeconomic stability. CADs of SEE countries, with the exception of FYR Macedonia, consistently widened since 2000, reached an average of 8.8 percent in 2005, and rose further in 2006. While there are mitigating circumstances (see the third section of this chapter), the persistence of such deficits is likely to raise increasing concerns about macroeconomic stability. Moreover, to the extent that large privatizations are complete, FDI financing of CADs in several countries can no longer be taken for granted.

Thus, the environment for sustained, export-led growth is expected to become more difficult for SEE5 countries; hence, the context for this study. For all the above reasons, sustained growth cannot be taken for granted, but the EU will help provide an incentive/anchor for reform as well as the opportunities for deeper integration.

The objective of the study is to analyze selected issues that could have a potentially significant impact on growth and, by implication,

exports. In particular, issues relating to deeper economic integration, trade in services, and selected aspects of the business environment are considered. Some of the questions this study deals with include: Can SEE countries improve competitiveness through deeper regional integration, such as by encouraging supply chains and trade in services? Can integration be used creatively to reduce costs of investment and regulation? Within the large business environment agenda, what could be priorities for governments to focus on? How important is human development in the overall agenda to accelerate exports and sustain growth?

The report suggests that SEE5 countries may need to avoid a possible “middle-income trap.” This means that they have a certain structure of production and exports that competes with countries with a more competitive wage structure, such as China.³ Moreover, SEE5 countries may find it increasingly harder to move into product spaces already occupied by lower-wage countries such as China and India, even as the world becomes increasingly globalized. In addition, SEE5 countries are surrounded by countries that are larger and more attractive for foreign direct investment, which raises the question as to whether and how they can attract a sustained flow of high-quality investment. This study poses these and related questions, and seeks to provide possible ways of addressing them.

The study often focuses on SEE as a unit. On the one hand, this study is about development in the SEE5 countries. On the other hand, regional integration has been increasingly encouraged since the EU-initiated Stability Pact for South Eastern Europe began in Cologne in 1999 (Moldova is the other country in the Stability Pact). Because the impact trade and regional integration have on growth form core elements of the report, the unit of analysis often shifts to the level of SEE.

The rest of this chapter is organized as follows. The next section links the implicit theoretical framework to the questions posed in this report. The third section places the subsequent analysis of the report in the context of large and often rising CADs, which serve as a reminder that macroeconomic stability is a necessary condition for sustained growth.

The Implicit Theoretical Framework

With sustained growth being the objective, the implicit theoretical framework of this study is the growth accounting/production function

approach. Growth can be increased through a combination of increases in capital investment, labor (quantity and quality) and improvements in TFP.

The proximate filter is export growth, with the underlying assumption that export growth is good for economic growth. This is true in any case if the target is net exports,⁴ but this paper proposes to go further and offers that any action that would increase (gross) exports in the long run would also increase GDP-growth.

The paper will explore selective ways to increase growth rates of K and L (utilization of capital and labor is low) in order to sustain and find new sources for the growth of TFP. The analytical link between the areas proposed for analysis and K, L, and TFP will be made in the following paragraphs.

Capital Accumulation

Capital accumulation averages 20 percent of GDP in SEE5, which is probably too low for sustained growth. High-growth countries often see high investment rates, especially in East Asia (although this is not always the case).⁵ In SEE5, by contrast, investment rates average 20 percent of GDP and have not increased since the late 1990s (see also the section on investment rates later in this chapter). The hypothesis is that investment rates, particularly private investment, need to increase in order to raise and sustain growth, especially because reallocation-based gains in TFP have most likely run their course in many countries in the post-transition.

In SEE5, given already large CADs, the most obvious reason for low investment rates appears to be low domestic (private) savings. On the other hand, a more productive use of foreign savings would also foster investment. Thus, even within the same or lower level of CADs, a higher share of FDI-originating CADs would help increase overall investment rates. This, of course, leads to the question of the determinants of FDI, which is the subject of much of this report. Finally, the identity $S - I = X - M$ shows that low domestic savings are consistent with low exports; this is another issue examined in this paper.

This report explores low domestic-private savings indirectly, through the lens of corporate profitability, and assumes that the investment climate and provision of key services are crucial determinants of profitability. The hypothesis is that low private enterprise savings are linked to low enterprise profitability; similarly, low investment demand is also linked to low enterprise profitability. Enterprise profitability, in turn, depends

on the business environment, the price and quality of infrastructure services, the size and contestability of the market (especially the input market, hence the role of deeper integration), and unit labor costs.

Growth in Labor (Quality and Quantity of Labor Skills)

Low levels of labor force participation and the high degree of informal employment undermine the growth potential in the Western Balkan countries. Labor force participation rates (see table 1.1) vary from 52 percent in Kosovo to 74 percent in Bosnia and Herzegovina, and average about 65 percent for SEE. Participation rates in the EU25 are 70 percent. Moreover, high levels of informal employment tend to reduce productivity and undermine revenue collection and fair competition. Unemployment levels are also much higher than in EU25.

The low use of L in the production function will be explored in this report through an analysis of high costs and inadequate quality of labor skills. The report will flag the issue of human capital development as a priority for sustaining growth. Improved skills will lead to increased employability of labor and will also endogenize the creation of new enterprises through the creation of more entrepreneurs. In some countries, such as Bosnia and Herzegovina and FYR Macedonia, high labor costs also appear to be an issue.

TFP Growth

Private-sector TFP growth is ultimately the most sustainable source of long-run growth. Growth is driven by the private sector throughout the world, and 90 percent of all jobs are provided by the private sector. In SEE5, the private sector on average comprises only 58 percent of GDP (Albania and FYR Macedonia, however, have higher shares) versus 78 percent for the EU8.

However, much of the private sector in SEE5 is not competitive, and cannot provide sustained growth and job-creation. Low exports to GDP ratios and merchandise trade deficits in excess of 20 percent are indicators of the lack of competitiveness.

TFP growth can occur in many different ways. The challenge is to find new sources of TFP growth. In this report, the link will be made through the investment climate. SEE5 countries need to accelerate the growth of exports and also move toward more skill-intensive exports. The link with these objectives will be made, *inter alia*, through the investment climate, skill development, and expanding regional integration. These changes are expected to increase TFP growth.⁶

Table 1.2. Key Indicators, Montenegro and UNMIK/Kosovo

	<i>GDP growth average (2002-2006)</i>	<i>Fiscal balance (% GDP, 2006)</i>	<i>Current account balance (% GDP, 2006)</i>	<i>FDI (% GDP, 2006)</i>	<i>Gross domestic investment (% GDP, 2006)</i>	<i>GDP per capita^a (current US\$)</i>	<i>External debt (% GDP, 2006)</i>	<i>Sovereign rating (S&P) 05/2007</i>	<i>Unemployment rate (% 2006 or latest year available)</i>
Montenegro	4.3	1.1	-26.0	23.7	36.2	3,540	49.0	BB+	14.7
Kosovo	1.9	3.4	-19.3	10.2	30.3	1,380	—	—	45

Source: National authorities; World Bank regional tables.

a. Montenegro data is for 2006 and Kosovo data is for 2005.

A Preliminary Analysis of Current Account Imbalances in Southeast Europe

Introduction

Current account deficits (CADs) among the countries of SEE have widened substantially since 2000, have reached levels above those observed in most other emerging-market countries, and are currently in excess of conventional benchmarks of vulnerability.⁷ The increase in external deficits has been accompanied by substantial fiscal adjustment in most countries and by progress in advancing structural reforms, including rapid bank privatization. The simultaneity of worsened external imbalances with improved fiscal and structural policies challenges the conventional wisdom. This creates a policy conundrum for those governments that embark on fiscal tightening to help offset vulnerabilities arising from widening external shortfalls.

Wider CADs in recent years have been part of the process of convergence of SEE countries and are facilitated by abundant global liquidity, significant financial deepening, and increasing openness of the economies in the region. Understanding current account imbalances in the region should help assess vulnerabilities and strongly underpin the policy response. Even though wide CADs are driven at least partly by convergence factors and increasing financial integration,⁸ they nevertheless represent vulnerabilities that need to be addressed. Focusing solely on tightening fiscal policy, however, will not achieve results. Boosting the economies' productive and export capacity, which would ultimately result in narrower deficits and help reduce the countries' foreign liabilities, will require structural and institutional reforms. Tighter prudential banking supervision is needed to ensure that banks account properly for the risks inherent in surging credit portfolios. This is important because foreign investors may misjudge some of the risks associated with large capital flows, as has happened often in more developed parts of the world.

In addition to the correlation observed between deterioration in CADs and improvement in fiscal deficits, two other observations help explain the recent developments. First, there has been a strong negative correlation between public and private savings in the region. Second, there is a robust and high positive correlation between national savings and domestic investment; the correlation is well-documented for developed countries (i.e. the Feldstein-Horioka puzzle, see Feldstein and Horioka (1980)). These observations support the conclusion that prudent fiscal policy must accompany determined structural and financial sector

Box 1.1**Exchange Rates in the Western Balkans**

The table below shows estimated deviations of real effective exchange rates from their medium-term trends (estimated from quarterly data) for SEE countries together with potential determinants of such deviations, including labor-productivity growth, terms-of-trade growth, the real interest rate, and external debt. The last column shows the type of applied exchange rate regime in a given country.^a Positive labor productivity growth or terms-of-trade growth is expected to result in an appreciation of the equilibrium exchange rate. An inflow of remittances can have a similar impact provided that it is permanent or at least longer than medium term. If such an inflow is temporary, it can be seen as affecting the deviation of the exchange rate from its equilibrium rather than affecting the equilibrium itself. Similarly, a positive interest rate^b makes the actual exchange rate deviate from its equilibrium. External debt is used here as an indicator of an exchange rate risk premium which also contributes to a deviation of the exchange rate from its equilibrium. The exchange

Deviations of Real Effective Exchange Rates from Their Medium-Term Trends (Q1 2001–Q2 2007) and Key Indicators in 2006

	<i>Exchange rate misalignment vs. trend (%)</i>	<i>Labor productivity growth (%)</i>	<i>Terms of trade growth (%)</i>	<i>Remittances (% GDP)</i>	<i>Real interest rate (%)</i>	<i>External debt (% GDP)</i>	<i>Currency arrangement</i>
Albania	0.4	4.8	-2.7	15.4	9.3	16.8	Loosely managed float
Bosnia and Herzegovina	2.5	-5.2	0	19.5	8.1	52.2	Currency board
Croatia	6.1	5.2	1.0	3.1	7.8	89.6	Tightly managed float
FYR Macedonia	0.2	-4.0	-1.1	3.9	8.7	38.8	De facto euro peg
Montenegro	-2.0	5.0	1.3	17.7	8.3	61.3	Euro
Serbia	2.9	-3.4	1.3	17.7	1.5	62.1	Tightly managed float

Source: The table was calculated using data from the International Financial Statistics and the Central Database of the World Bank. Labor productivity growth calculations are based on real GDP and labor force data.

Note: Exchange rate misalignment is a percent deviation of REER from its estimated trend using double exponential smoothing. A positive sign indicates an overvaluation compared to the trend.

(continued)

rate is expressed here as units of foreign currency (basket) per unit of domestic currency, so that an upward movement in the exchange rate represents relative appreciation of the domestic currency.

Overall, the exchange rates show a mild positive deviation from the medium-term trend, suggesting slight overvaluation of the currencies. The real effective exchange rates closest to their equilibriums are those of Albania and Macedonia, while Croatia shows the most positive deviation of about 6 percent. On the other hand, only the exchange rate of Montenegro shows a negative deviation from its trend, implying a possible undervaluation of the currency. The absolute value of the estimated deviations do not seem to be strongly associated with the applied exchange rate regimes (although a mechanical filtering as done here is not expected to yield a good estimate of an exchange-rate equilibrium and is likely to show low or zero misalignments of managed exchange rates).

For the sake of interpretation, Croatia's case is instructive. Strong labor productivity growth in Croatia is expected to make its currency appreciate through the Balassa-Samuelson effect, so that the equilibrium exchange rate increases. Additional appreciation pressure would arise from the positive real interest rate. On the other hand, the high external indebtedness of Croatia may result in a significant risk premium on the currency, and a decline in the actual exchange rate. There is not much impact from terms-of-trade growth, and the inflow of remittances is rather low in the regional context. What we finally observe is therefore an indication of a possible overvaluation of the currency beyond the equilibrium appreciation implied by productivity growth (which is assumed to be reflected in the medium-term trend).

It is difficult to draw any firm conclusions as to the degree of overvaluation (or otherwise) of exchange rates based on this limited exercise. In general, regimes of managed exchange rates can lead to exchange-rate misalignments, which in turn can hinder export performance and result in accumulation of external imbalances. The exchange rate is a very important adjustment mechanism for an open economy. If this adjustment mechanism is not flexible enough, the adjustment has to go through domestic markets, such as through prices, production volumes, and wages. In turn, the often inflexible nature of such markets in transition countries calls for structural reforms to increase their flexibility. To sum up, exchange-rate management in the Western Balkans may call more strongly for structural reforms, *ceteris paribus*.

a. See Sorsa (2006) for more details of exchange rate arrangements in SEE.

b. The formulation for interest rates as well as all other variables should be in terms of differentials compared with comparators. Here, we assume that most of the variation in REERs is due to changes in domestic variables and implicitly assume no change in variables of foreign comparators.

reforms, since improved public savings are likely to provide only a small, and typically temporary, boost to domestic savings. Private savings become the key resource for boosting investment, which in turn require policies to boost corporate profitability. Improving corporate profitability will also help create demand for investment, which is low in SEE.

The Size of External Imbalances⁹

The CADs of the SEE countries have followed an upward trend since 2000. The region's CAD has widened from 4.1 percent of regional GDP in 2000 to 8.8 percent in 2005, compared with little change on average for all countries of emerging Europe.¹⁰ CADs rose substantially during 2000–05 among all SEE countries except in FYR Macedonia, where the CAD actually narrowed in 2005 and 2006 (see table 1.3). Given the policy advice, CADs have paradoxically widened most in countries where fiscal policies tightened most.

Higher prices for imported oil and natural gas added about 2.5 percentage points of GDP to the region's CAD between 2000 and 2005. This terms-of-trade shock has been partly offset for exporters of non-oil commodities whose prices also rose sharply, including metals (Bosnia and Herzegovina) and electricity (Bosnia and Herzegovina and Bulgaria). On

Table 1.3. Current Account Balances

(in percent of GDP)

	2000	2001	2002	2003	2004	2005
SEE ^a	-4.1	-5.4	-5.9	-6.9	-7.5	-8.8
Albania	-6.6	-5.8	-10.0	-8.1	-5.5	-7.6
Bosnia and Herzegovina ^b	-10.6	-13.9	-17.5	-17.3	-16.4	-18.1
Bulgaria	-5.6	-5.6	-2.4	-5.5	-5.8	-11.3
Croatia	-2.6	-3.7	-8.3	-7.2	-5.4	-6.6
Macedonia, FYR	-2.0	-7.1	-9.4	-3.2	-7.7	-1.4
Romania	-3.7	-5.5	-3.4	-6.0	-7.5	-9.0
Serbia and Montenegro ^b	-3.0	-3.5	-6.8	-7.2	-9.7	-7.5
Memoranda:						
			<i>(in percent of official GDP)</i>			
CEE, SEE, and Baltics	-4.8	-4.4	-4.7	-5.0	-6.1	-5.0
Bosnia and Herzegovina	-12.8	-16.8	-21.2	-20.9	-19.9	-21.9
Serbia and Montenegro	-3.9	-4.6	-8.8	-9.3	-12.6	-9.8
FDI, % of CAB in SEE	99.1	77.8	53.5	69.4	69.1	66.8

Sources: World Bank regional tables, selected IMF reports.

Note: The above pattern as implied in footnotes a and b to this table will be repeated throughout the tables in this section, but the footnotes will not be repeated.

a. Weighted by nominal US dollar GDP.

b. Relative to GDP adjusted upward for the size of the nonobserved economy (21 percent in Bosnia and Herzegovina and 30 percent in Serbia).

balance, terms-of-trade losses appear to have accounted for about one-half of the worsening of the external imbalances from 2000 through 2005.

Underlying the high CADs are relatively low levels of exports of goods and nonfactor services (GNFS). Exports of GNFS in 2005 amounted to 39 percent of regional GDP, compared with 68 percent in Hungary (see table 1.4). In Albania, an extreme case, exports per capita in euro terms amounted to only 8 percent of the level in Hungary. Of course, the low base of exports has also meant fast growth in most cases, leading to an increase in the share of GNFS exports in GDP, and in a rapid increase in per-capita exports. These initial observations are amplified in chapter 2, in which comparisons are made with Slovakia and other comparators. Despite high growth, the gap in volume of exports is still very large, especially for SEE5 countries. The slowest growth in per-capita exports occurs in FYR Macedonia, which is interesting because of its very low CAD. This suggests low foreign investor confidence (and thus small capital inflows), low domestic demand for foreign savings, or both.

FDI-inflows rose by about 2 percent of regional GDP from 2000 until 2005, which was much less than the region's CADs widened and thus coverage declined. FDI-inflows covered just two-thirds of the deficit in 2005, down from almost full coverage in 2000 (see table 1.3).¹¹ However, regional averages of FDI inflows hide significant variations. For example, inflows as a share of GDP rose substantially in Serbia and Montenegro, Romania, and Bulgaria (with Bulgaria having the highest levels), whereas inflows fell relative to GDP in the other countries, and FYR Macedonia experienced the largest decline (see table 1.5).¹²

Table 1.4. SEE: Exports of Goods and Services

(in euros per capita unless otherwise indicated)

	2000	2001	2002	2003	2004	2005	2000–05, % change	2005, GNFS % of GDP
SEE								38.9
Albania	213	291	322	391	447	458	115.2	21.8
Bosnia and Herzegovina	392	467	473	606	688	753	92.0	40.1
Bulgaria	815	998	1,073	1,364	1,581	1,670	104.9	60.3
Croatia	1,851	2,359	2,663	3,559	3,509	3,595	94.3	51.5
Macedonia, FYR	759	747	749	886	907	994	31.1	43.6
Romania	511	648	810	1,004	1,104	1,210	136.6	33.2
Serbia and Montenegro	287	358	436	536	611	683	138.4	26.9
Hungary	3,690	4,184	4,423	4,565	5,329	5,925	60.6	67.9

Sources: National authorities; IMF, selected reports.

Table 1.5. Net Inflows of Foreign Direct Investment*(in percent of GDP)*

	2000	2001	2002	2003	2004	2005
SEE	4.0	4.2	3.1	4.8	5.2	5.9
Albania	3.9	5.0	3.0	3.2	4.6	3.1
Bosnia and Herzegovina	2.4	1.9	3.6	4.0	5.5	2.5
Bulgaria	7.9	5.9	5.9	10.5	13.9	10.8
Croatia	5.9	6.0	2.9	6.8	2.6	3.8
Macedonia, FYR	4.9	12.8	2.0	2.1	2.9	1.7
Romania	2.8	2.9	2.5	2.2	4.2	6.3
Serbia	0.2	1.1	2.8	5.2	3.2	5.9
Memoranda:						
			<i>(in percent of official GDP)</i>			
ECA	2.6	2.6	2.5	1.3	2.3	3.0
CEE, SEE, and Baltics	5.8	4.6	5.3	1.8	4.2	4.5
Bosnia and Herzegovina	3.0	2.3	4.3	4.9	6.6	3.0
Serbia and Montenegro	0.3	1.4	3.6	6.8	4.2	7.7

Sources: World Bank regional tables; selected IMF reports.

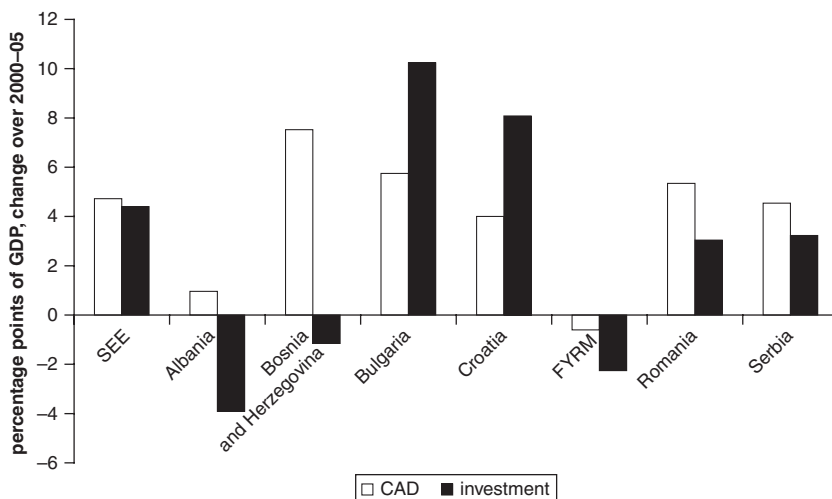
Gross external debt in SEE has fallen from about 52.5 percent of GDP in 2000 to 47.7 percent in 2005. Wider CADs have been financed by foreign direct investment, capital transfers from foreign donors, and other non-debt-creating inflows of uncertain composition and kind. Serbia and Montenegro's external debt fell by over 54 percentage points of GDP (see table 1.6), which was driven by debt cancellations. Bulgaria undertook pre-payment of Brady bonds to achieve its debt reduction. Croatia's external debt rose by the largest amount relative to GDP. Overall, the broad stability of external debt despite the wider deficits and lower FDI coverage may indicate a possible upward bias in the measurement of CADs. This study does not address this issue, but notes that in Bosnia and Herzegovina, positive errors and omissions inflows were about 5 percent of GDP on average in recent years, despite a fairly well-understood capital account composition. This suggests that errors and omissions reflect current account transactions. In Albania, errors and omissions, which include unidentified private transfers, rose from 0.3 percent of GDP to 2.8 percent of GDP in 2006 (IMF 2007b).

Changes in CADs are typically judged as less of a concern if they reflect higher investment rather than lower savings. The following subsections address these issues and note that while CADs increased, gross domestic investment rose by about 4 percent of GDP from 2000 to 2005 for the region as a whole. At the same time, national savings fell only by about 0.75 percent of GDP (see figure 1.1).¹³

Table 1.6. Gross External Debt*(in percent of GDP)*

	2000	2001	2002	2003	2004	2005
SEE	52.4	49.9	48.7	50.6	49.9	47.7
Albania	31.6	28.5	25.2	22.2	20.2	19.7
Bosnia and Herzegovina	43.8	40.7	43.6	48.4	46.6	45.0
Bulgaria	86.9	78.6	65.1	60.2	64.4	67.4
Croatia	61.2	59.8	68.0	83.6	87.9	78.5
Macedonia, FYR	43.2	43.5	43.3	39.6	37.9	39.2
Romania	28.7	30.7	33.4	33.3	32.0	33.5
Serbia and Montenegro	102.0	79.4	58.7	53.2	47.0	47.6
Memoranda:						
Czech Republic	38.0	35.0	33.7	35.0	36.6	38.6
Estonia	54.7	55.7	60.2	70.5	84.1	90.5
Hungary	65.0	61.4	53.8	64.7	66.3	75.2
Latvia	61.0	67.7	75.7	82.6	82.8	87.9
Lithuania	43.7	43.9	44.0	45.2	43.1	43.2
Poland	38.7	36.8	40.3	47.5	41.6	42.9
Slovak Republic	53.4	52.9	54.1	55.4	45.1	38.4
Slovenia	46.4	47.7	48.9	54.1	59.4	62.1

Sources: Quarterly External Debt Statistics, World Bank/IMF; national authorities.

Figure 1.1. SEE: Change in Current Account Deficits and Change in Investment Rates

Sources: World Bank World Development Indicators database; World Bank ECA regional tables.

Savings Rates

National savings rates fell from about 15 percent of regional GDP in 2000 to 14.3 percent in 2005. These reflect sharp declines in Bosnia and Herzegovina and Albania, and to a lesser extent in FYR Macedonia, Romania, and Serbia and Montenegro. Savings rose (sharply) in Bulgaria and Croatia (see table 1.7). Public savings rose during 2000–05 for all countries in the region except FYR Macedonia (where they fell sharply). This means that private savings in most countries continued to fall and dissavings in Bosnia and Herzegovina increased (see tables 1.8 and 1.9). The decline in public savings in FYR Macedonia in 2001 and 2002 reflects the ethnic conflict.¹⁴

Table 1.7. Gross National Savings

(in percent of GDP)

	2000	2001	2002	2003	2004	2005
SEE	15.1	14.9	14.3	15.0	15.8	14.3
Albania	20.8	23.0	16.1	17.3	20.6	15.9
Bosnia and Herzegovina	6.4	1.7	-0.7	-0.4	-0.9	-2.2
Bulgaria	12.7	17.0	19.1	17.4	19.0	17.2
Croatia	19.2	18.1	14.0	22.4	24.5	23.3
Macedonia, FYR	20.2	12.0	11.2	16.8	13.7	18.6
Romania	15.5	15.9	17.8	14.6	14.9	13.2
Serbia and Montenegro	7.9	7.0	5.5	7.3	7.8	6.4
Memoranda:						
				(in percent of official GDP)		
Bosnia and Herzegovina	7.8	2.1	-0.8	-0.5	-1.1	-2.7
Serbia and Montenegro	10.3	9.1	7.2	9.5	10.1	8.4

Sources: World Bank regional tables; selected IMF reports.

Table 1.8. Public Savings

(in percent of GDP)

	2000	2001	2002	2003	2004	2005
SEE	1.3	1.4	1.5	2.1	3.2	3.7
Albania	-1.6	-0.6	0.0	-0.1	0.1	1.2
Bosnia and Herzegovina	0.3	1.0	0.9	3.0	3.8	4.9
Bulgaria	6.8	6.4	4.1	4.6	7.0	8.4
Croatia	-0.7	-0.5	1.4	1.5	2.9	3.2
Macedonia, FYR	5.1	-3.0	-2.0	4.1	3.6	2.4
Romania	0.3	1.4	1.8	2.0	2.6	2.8
Serbia and Montenegro	1.8	1.0	-0.5	-0.5	1.8	2.7
Memoranda:						
				(in percent of official GDP)		
Bosnia and Herzegovina	0.4	1.3	1.1	3.6	4.6	5.9
Serbia and Montenegro	2.4	1.3	-0.6	-0.6	2.4	3.5

Sources: World Bank regional tables; selected IMF reports.

Table 1.9. Private Savings*(in percent of GDP)*

	2000	2001	2002	2003	2004	2005
SEE	13.8	13.5	12.8	12.9	12.6	10.6
Albania	22.3	23.6	16.1	17.4	20.5	14.7
Bosnia and Herzegovina	6.1	0.7	-1.6	-3.4	-4.7	-7.1
Bulgaria	6.0	10.6	15.0	12.8	12.0	8.8
Croatia	19.9	18.6	12.6	20.9	21.6	20.1
Macedonia, FYR	15.2	14.9	13.2	12.6	10.1	16.2
Romania	15.1	14.5	16.0	12.6	12.3	10.4
Serbia and Montenegro	6.1	6.0	6.0	7.8	5.9	3.7
Memoranda:			<i>(in percent of official GDP)</i>			
Bosnia and Herzegovina	7.4	0.8	-1.9	-4.1	-5.7	-8.6
Serbia and Montenegro	7.9	7.8	7.8	10.1	7.7	4.9

Sources: World Bank regional tables; selected IMF reports.

Our estimates suggest that corporate savings fell from 2003 through 2005 in Albania, Bosnia and Herzegovina, Bulgaria, and Romania, but rose in FYR Macedonia and Serbia and Montenegro.¹⁵ The drop was most pronounced in Bosnia and Herzegovina (about 9 percent) and Bulgaria (8 percent) (see annex tables 1.1 and 1.2). These numbers should be interpreted with care. The estimation is from the equation that links household incomes to household consumption (derived from national accounts or estimated indirectly), household savings (proxied by bank deposits) and household consumer credits. For Serbia and Montenegro only, the study uses the outcomes of a report that directly measures corporate profitability (Cvetkovic and Lieberman 2006).

Corporate savings amounted to 8 percent of regional GDP in 2005, and the low and declining level remains a key explanation for low investment rates. It is possible that the decline in savings is a result of reduced profitability, in turn reflecting more competitive market conditions (see chapter 2). Whatever the reason, the problem would need to be addressed through measures that improve the business environment and render production costs more competitive. This is the subject of much of this report.

Deterioration in CADs is positively correlated with improvements in fiscal balances (changes in public savings) for SEE, which partly reflects improved confidence by foreign investors. This correlation is strong for the countries in the region and for the economies of emerging Europe. This study builds upon Mukhopadhyay (2006) but tests the hypothesis of convergence using a cross section rather than a time series. This is presented in the annex, table 1.3. Model 1 of annex table 1.3 seems to best

capture developments.¹⁶ The analysis demonstrates that fiscal prudence, determined implementation of structural reforms, and stronger output growth have been associated with larger CADs as countries tap foreign savings (and foreign investors develop more confidence to invest) to accelerate convergence.¹⁷ Countries with currency boards also tend to have larger CADs, reflecting the oft-quoted “overborrowing” syndrome related to fixed-exchange-rate regimes.¹⁸

The correlation between changes in current-account and fiscal balances are related to the policy advice countries have received. Annex table 1.4 displays outcomes and projections for key macroeconomic variables under IMF supported programs (for Croatia, the projections are forecasts in Article IV documents). Countries committed under Fund-supported programs (as per Fund documents of 2002 or before) to tighten fiscal deficits by 1.4 percentage points of regional GDP (weighted by nominal GDP) from 2002 to 2005. The intent was to help reduce CADs by 1.5 percentage points of regional GDP. Notice the one-to-one correspondence between the two, reflecting the understanding that there should be one-to-one offset between an increase in public savings and a decrease in foreign savings. In reality, fiscal deficits were tightened by 2.5 percentage points of regional GDP, while CADs widened by 2.3 percentage points. There are two key exceptions, FYR Macedonia and Albania, for which the standard policy advice of tightening fiscal deficits was accompanied by reduced CADs. In the case of FYR Macedonia, the development likely reflected investor concerns (see above).

The data for the SEE countries display a strong negative correlation between public and private savings. The correlation coefficient between change in public and private savings during 2000–05 increases almost threefold to 0.9 if Bulgaria and Croatia are excluded from the sample. For Bulgaria and Croatia, the correlation tends to be positive. The negative correlation is likely to reflect a link similar to the one between the CADs and fiscal deficits: increased public savings afford more room for the private sector to expand capacity and consumption in the process of convergence.

Investment Rates

Investment rates among the SEE countries are substantially lower than among the EU8 countries. This bodes poorly for future growth (see table 1.10).

Excluding Bulgaria and Croatia (countries where investment rates in 2005 were in line with the EU8 average), investment rates in the

Table 1.10. Gross Domestic Investment*(in percent of GDP)*

	2000	2001	2002	2003	2004	2005	Change, 2000–05	
SEE	19.1	20.5	20.5	21.9	23.5	23.5	4.4	
Albania	27.4	28.8	26.1	25.4	26.1	23.5	-3.9	
Bosnia and Herzegovina	17.0	15.6	16.9	16.9	15.5	15.9	-1.2	
Bulgaria	18.3	22.6	21.5	22.9	24.8	28.5	10.2	
Croatia	21.8	21.8	22.3	29.6	29.9	29.9	8.1	
Macedonia, FYR	22.3	19.1	20.6	20.0	21.4	20.0	-2.3	
Romania	19.1	21.4	21.2	20.6	22.4	22.2	3.0	
Serbia and Montenegro	10.9	10.5	11.7	11.4	17.3	14.2	3.2	
Memoranda:								
			<i>(in percent of official GDP)</i>					
ECA	22.9	21.8	21.4	22.0	23.1	22.7	-0.2	
CEE, SEE, and Baltics	26.0	26.6	26.7	25.1	27.5	28.6	2.6	
Bosnia and Herzegovina	20.6	18.9	20.4	20.4	18.8	19.2	-1.4	
Serbia and Montenegro	14.2	13.6	15.2	14.8	22.5	18.4	4.2	

Sources: World Bank regional tables; selected IMF reports.

remainder of the region have remained relatively consistent at about 20 percent of GDP during 2000–05 when compared with increases of about 10 percent of GDP in Bulgaria, 8 percent in Croatia, and 2.6 percent on average among the EU8. Investment rates in Romania also increased, but only by about 3 percent of GDP. Investment rates in Serbia and Montenegro and Bosnia and Herzegovina are the lowest among the ECA countries (even when measured relative to official GDP), followed by Poland, FYR Macedonia, and Albania.

The data suggest a strong and positive correlation between national savings and investment rates, regardless of the degree of openness of economies. This correlation is well-documented for developed countries (i.e., the Feldstein-Horioka puzzle) and holds true for the countries in the region. The correlation between national savings and investment rates in SEE was 0.8. Further, among the SEE countries, the largest increases in investment during 2000–05 were in Bulgaria and Croatia, countries with the largest increases in national savings. Both countries, moreover, had large increases in their CADs, as noted above. Bulgaria's was the largest increase in the region.

Given the above link, domestic savings become extremely important. It suggests that governments should focus on boosting domestic savings to help finance domestic investment and try to limit vulnerabilities related to tapping foreign savings. This also means that once fiscal prudence is secured (and hence public savings are appropriate), policies should

focus on boosting domestic private savings. This suggests a focus on advancing structural and financial sector reforms.

Overall, reforms that result in stronger corporate profitability and prudent bank lending are key to increasing incentives for foreign investors and to strengthening domestic savings and investment. Together with increased investment in human capital arising from reforms in education and other key areas, higher investment rates should boost growth in output and employment.

Finally, to reiterate, while the growing CADs in the region could perhaps be explained by relatively benign factors, the sustainability of external finances will demand strong attention to structural reforms. Some of these concerns are addressed in this report.

Notes

1. SEE5 refers to Albania, Bosnia and Herzegovina, the Former Yugoslav Republic of Macedonia (FYR Macedonia), and Serbia and Montenegro. It refers to the geographical area that is included in these countries, and so remains SEE5 even after Montenegro became a separate nation in 2006. The Western Balkans is SEE5 plus Croatia. Bulgaria, Croatia, and Romania (BCR) plus SEE5 refer to SEE.
2. See World Bank (2007c), appendix 1. Looking at individual countries, Albania and Croatia (as well as Turkey) show significant decline in TFP growth between the two periods. In the case of FYR Macedonia, the TFP contribution to growth increases marginally over the two periods.
3. See World Bank (2007d) and Beattie (2007). These documents point to the increasing export of more sophisticated products from China, which are hurting its immediate middle-income Asian neighbors.
4. In terms of the simple identity, $Y = C + I + G + (X - M)$, where Y is income, C , I , and G are consumption, investment, and government expenditure respectively, and $X - M$ is net exports.
5. For example, Estonia grew at 0.2 percent per year from 1990–2000, and 7 percent per year from 2000–04, whereas its investment rate over the same period grew from 0.2 to 12 percent per year, and the investment to GDP ratio rose from 27 to 31 percent over the entire period.
6. The factors that influence TFP growth are not fully understood in the literature. In fact, in the production function approach, TFP growth is calculated as a residual. There are also problems of measurement of K and L , which can result in an attribution of GDP growth to the residual (for example, if improvements in the quality of K and L are not fully captured).

7. This section is based on a mimeo by Ivailo Izvorski. It includes all countries of South East Europe, incorporates data up to 2005, and hence refers to Serbia and Montenegro and not Serbia.
8. For example, Abiad et al. (2007) find that in Europe, a country's CAD is higher the lower its income level and the higher its degree of financial integration. IMF (2007c, chapter 2 in part 2) points to the strong convergence in income levels in Europe (fastest progress in the Baltics, Bulgaria, and Romania), as well as the negative correlation between per capita income and the CADs in Europe.
9. The data in this section is not exactly the same as in the rest of the report, as it has been drawn from different sources, including the World Bank and the IMF. However, the important point here is not the absolute magnitudes, but the relationships analyzed as well as the changes over time.
10. Averages in this section of the chapter are weighted by nominal GDP. The nominal GDPs for Bosnia and Herzegovina and Serbia and Montenegro are adjusted upward by 21 percent and 30 percent respectively to account for the size of the nonobserved economy; an adjustment that does not reflect the official views of the World Bank or the countries' statistical authorities. The adjustment for Bosnia and Herzegovina is smaller because the authorities made an upward correction of 9 percent in mid-2006 to reflect imputed rent.
11. These levels are likely to be lower for inflows of direct equity investment, given that a large share of the inflows into Bulgaria, Romania, and some of the other countries have been in the form of inter-company borrowing from foreign parents.
12. Note that while table 1.5 shows FDI as a share of GDP, table 2.8 reports FDI per capita.
13. The text uses the equation: current account balance = national savings – gross investment. Government savings (see definition in next note) is calculated from government finance statistics. Private savings is the residual from the above equation. Within private savings, the paper uses corporate savings as primary (as calculated in a paper quoted below Cvetkovic and Lieberman (2006) and derives household savings as a residual for Serbia. For the other countries, household savings is primary, corporate savings is the residual.
14. In the metric used here, government domestic savings equals revenues less the sum of current noninterest spending and domestic-interest payments.
15. This data pertains to 2004 and 2005 only.
16. The change in the current account balance relative to GDP from 2000 to 2005 is the dependent variable, and is regressed on change of the fiscal balance (relative to GDP) over the same period, the change in GDP relative to Slovenia, the change in the EBRD structural reform score, and a dummy equal to 1 for countries with a currency board arrangement.

17. As noted earlier, the IMF (2007c) report shows that the lower the initial income per capita, the higher the size of the CAD, noting that initial per capita income is positively correlated with convergence. In annex table 1.3 of this report, we use GDP growth (relative to Slovenia) and the degree of reforms to indicate convergence.
18. Somewhat surprisingly, the coefficient on the dummy is significant only when the dummy refers to a currency board (and Latvia's peg); if a dummy for fixed pegs is included, the coefficient is insignificant.