Small open economies in the Western Balkans: Controlled fiscal expansion for a new deal for the Western Balkans

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Economic strength of the Western Balkans and relevance of the theory of a small open economy for the region

The area of the Western Balkans is approximately 248,000 square kilometres, which is equivalent to 95% of the United Kingdom (UK). The total population of the Western Balkans is 23 millions – which is approximately 35% of the population of the UK. The region’s GDP in 2010 accounted for 0.25% of world GDP, while its share in world population was 0.32%.

The Western Balkan countries implemented the main elements of financial and trade liberalization by the end of 2006. Since financial liberalization was carried out quickly and allowed for the free entry of foreign banks into the banking systems of Western Balkan countries, the banking sector of Western Balkan countries is now majority-owned by banks from Austria, Italy, France, Slovenia and Greece.

The monetary and foreign exchange regimes of Western Balkan countries are different. Albania has adopted a free floating exchange rate regime; Croatia and Serbia have adopted a managed float regime; Bosnia and Herzegovina has operated under the currency board regime with a fixed peg of the national currency to the euro; FYR Macedonia has implemented a de facto pegged regime; and Montenegro and Kosovo have a unilateral euroization.

The scope of the central banks in the region (Albania, Croatia, Serbia, FYR Macedonia) to carry out a discretionary monetary policy is very limited, and in Bosnia and Herzegovina it is eliminated by the Law on Central Bank with an exception of the required reserves policy (the least efficient monetary policy instrument in practice). Since Montenegro and Kosovo have adopted the euro as a means of payment, their central banks have also required reserves as the only monetary policy instrument available for implementation.

The financial systems of countries in the region are predominantly reliant on financing through commercial banks, although insurance companies, leasing companies, and investment companies are an integral part of the financial system. The supply of additional liquidity to the real sector is almost entirely dependent on the lending activity of commercial banks. Since the banks in the region are majority-owned by banks from the EU, financial cycles in the banking sector of Western Europe have a direct impact on credit activity of the banks in the region.
Relevance of the Mundell-Fleming model

The theoretical basis for considering the room for an active implementation of economic policy instruments in the small open economies in the Western Balkans is the Mundell-Fleming model. According to the model in a small open economy that has consistently adopted all the measures of financial and trade liberalization there is no room for an active monetary policy role. Money supply is completely (or almost completely) endogenous meaning that the central bank has no possibility to influence the money supply process and the interest rate. The interest rate is determined in the international money market.

Under conditions of perfect capital mobility and openness of the markets in goods, money, and bonds, a small economy can increase public expenditures in two ways:

- by issuing bonds and
- by raising tax rates.

The quantity of money is determined endogenously as a result of the quick changes of types of assets, at a globally determined basic interest rate.

Analysis of the effects of public consumption in the theoretical model of perfect capital mobility depends on the exchange rate regime: i.e. fixed or flexible exchange rate policy. Focusing on the pure impact of fiscal policy, in this context, would mean the absence of active monetary policy, or in other words, the extent that a country follows an expansionary fiscal policy by issuing public debt, the central bank shall not act as a buyer of bonds. Analysis of the fiscal policy impact in the context of perfect capital mobility assumes the distinction of short-term from long-term impact under two models:

- The model of fiscal policy based on tax increases (balanced fiscal policy) and
- The model of expansionary fiscal policy based on higher public debt, i.e. on bond issue with a passive role of the central bank (the central bank is prevented from buying government bonds).

In the first context, analysis of the impact of fiscal policy relates primarily to the influence of increased government spending based on higher taxes on the levels of production, debt, and interest rates under the two exchange rate regimes. Under a fixed exchange rate regime, expansionary fiscal policy creates induced changes in the money supply, while under a flexible exchange rate regime, induced changes take place in the exchange rate.

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1 See the Mundell-Fleming model in a Small Open Economy at: http://www.stanford.edu/~sandersn/101/Ch12_Handout.pdf
Also at: http://www.lagcc.cuny.edu/socialscience/economics/pdf/mundell_fleming_part5[1].pdf

One of the best books written about impact of fiscal policies on economic policies in a small open and big open economies, to my best knowledge, is that of Frenkel and Razin: Frenkel, Jacob, Assaf Razin (1987) Fiscal policies and the world economy, MIT Press, Cambridge, Massachussets.
The short- and long-term effects of the unit growth of public consumption in a small economy are financed in one model by debt issuance (bonds), in the other by rising taxes. The interest rate is determined exogenously due to the assumption of unlimited freedom of international capital flows. The production multiplier under a fixed exchange rate regime is typically the simple foreign trade multiplier. This result is logical, as the interest rate is exogenously determined in a small country. The fixity of the interest rate presupposes that the typical crowding-out effect, induced by changes in the interest rate, does not operate in this case.

Under flexible exchange rate conditions the short term production multiplier, as a consequence of expansionary fiscal policy, depends for the most part on the effect of debt revaluation induced by changes in the exchange rate. In fact, in the absence of such an effect (as would have been the case were the starting debt position zero), fiscal policy loses the ability to influence disposable income. In line with this, where rising national consumption is financed by bond issue, the production multiplier equals zero, but when financed by higher taxes, it equals one. Generally, the sign and the quantity of the short-term production multiplier depends on the size of already existing debt. In contrast, these quantities do not affect the quantity of the long-term production multiplier. In a world of perfect capital mobility and flexible exchange rates the long-term value of disposable income would not be affected by fiscal policy.

A very important characteristic of the interaction between fiscal and exchange rate policy in an open economy is the fundamental dependence of the directions of change of basic variables on the resources of fiscal policy, particularly as the shifting away from public consumption based on public debt issue towards higher public consumption financed out of tax changes the signs of the private debt multiplier ($\beta_f$), total cash holdings ($M$) and the exchange rate.

Higher government spending financed out of higher taxes under a fixed exchange rate induces a balance of payment deficit, reducing both short and long term cash holdings (the amount of money as property in the hands of private transactors). On the other hand, a similar rise in government spending financed by public debt issue (bonds) induces a positive balance of payments and increases cash holdings, over both short and long term.

Under a flexible exchange rate, higher public spending financed out of taxes causes depreciation over the long-term of the local currency, while higher debt-financed spending causes the currency to appreciate over the long term. Similar shifts in the direction of change of the exchange rate also have short term effects, but whether the currency appreciates or depreciates depends on the size of the debt, which in turn determines the impact of debt-revaluation.

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2The model was developed by Robert Mundell and Marcus Fleming.
3This theoretical proposition is very important for the practical economic policy making in developing countries and countries in transition.
4This theoretical proposition is relevant for the economic policy making in countries of the centre.
Fiscal Policy in Western Balkan countries

According to the average size of public debt, Western Balkan countries are not in the category of countries with a high level of public debt. Still, public debt figures need to be analyzed also in the context of total external debt, whose level is very high in some countries of the region (for instance, in Croatia). According to IMF figures, public debts of all countries in the region increased in the 2008-2011 period. Albania's public debt was the highest in the region, having increased from 55.1% (in 2008) to 59.4% of GDP (in 2011). In the same period, the public debt of Bosnia and Herzegovina increased from 30.8% to 43% of GDP, that of Croatia from 29% to 47.4% of GDP, that of Montenegro from 31.9% to 44% of GDP, that of Macedonia from 20.6% to 27.4% of GDP, and that of Serbia from 34.2% to 44.1% of GDP.\(^5\) It is indicative to compare changes in credit activity and fiscal discipline in the countries of the region also because of the fact that, according to figures of the European Bank for Reconstruction and Development, International Monetary Fund and World Bank, Albania appeared to be the only country in the region whose real GDP did not fall. In other words, Albania was the only country in the region and, together with Poland, the only country in Central and South-Eastern Europe to have achieved a real GDP growth in 2009. To recapitulate the aforementioned data, in 2009, Albania had a record-high budget deficit in the region. Moreover, its public debt in 2009 was 72% above the average public debt in the other five countries of the region (in 2009, Albania's public debt amounted to 59.8% of GDP, while the average public debt of the other five countries in the region amounted to 34.7% of GDP).

As for the structure of financial systems in the countries of the region, the most important institutions are commercial banks whose share in total financial sector assets ranges between 75% and 90%. Commercial banks in Western Balkan countries are predominantly owned by Austrian, Italian, Slovenian, Greek and French banks (although there are no Greek banks in Bosnia and Herzegovina and Croatia, and no Slovenian banks in Albania, where the second largest bank is Turkish). Therefore, credit activity of commercial banks in the Western Balkans is directly influenced by movements in the Western European financial markets. Each financial shock that hits Western Europe will soon spill over the region. Furthermore, the share of Western European foreign trade in the Western Balkan trade is approximately three-fifths. All major banks operating in the Western Balkans hold significant surpluses of liquidity reserves as a “shield” against possible shocks. The current year of 2012 is the year when parent banks in Western Europe will have to raise the bank capital to weighted assets ratio from 6% to 9% by the end of June. These measures will cause a lower inflow of funds into the region because new credit lines will be reduced significantly (or suspended completely). Banks in Western Balkan countries are faced with an increasing share of non-performing loans in the overall loan structure. From 2009 to the end of 2011, the average share of non-

\(^5\) Data on public debts of Western Balkan countries were taken from the International Monetary Fund "Country Info" webpage (www.imf.org – "Country Info").
performing loans in the total loan portfolio soared from 3% to as high as 15%. In such circumstances, it is not realistic to expect a significant credit expansion in the near future. Stagnation of lending activities, as mentioned earlier, is directly affecting the fiscal revenues of Western Balkan countries due to declining or stagnating personal spending and plummeting business investment, coupled with a growing illiquidity of the real sector.

Fiscal discipline, based on cutting expenditures for non-productive purposes, especially administrative expenditures and outlays for a sometimes unreasonable increase in social payments, is very useful and will become necessary. However, almost no country in Europe, either in its recent or more distant history, has managed to bail out of recession or to prevent recession from growing into depression, by means of sharply cutting public expenditures, particularly those expenditures that are aimed at creating new jobs or economically connecting the region. Of course, I am referring to capital expenditures which are essential for boosting the quality of business environment and connecting the countries of the region, which, in turn, would pave the way for the implementation of joint business venture projects and development of cross-border clusters. Some countries of the region, like Bosnia and Herzegovina and Serbia, and partly Croatia, still own dominant or significant shares in large and profitable companies. This ownership may be used as a guarantee for issuance of government securities, whose sole purpose would be to finance development projects. I shall conclude my paper on fiscal policy in the Western Balkan countries with a section that contains my proposal for a possible way out of the "vicious circle" that we have found ourselves in, though I have no illusions with regard to its weaknesses and possible criticism it may cause. However, in the modern financial market structure that the Western Balkan market is also part of (although regrettably still disunited), banks and other financial institutions (investment funds and insurance companies) in the region need more secure financial instruments which would ensure more successful portfolio management and also allow for a pro-development utilization of the available potential, which is still idle.

**Euro-Balkan Bonds and Regional Development**

My proposal of a possible way out of the “vicious circle until we hit rock bottom” at the time of crisis is based on the issuance of new types of financial instruments which can influence simultaneous achievement of the following goals:

- higher profitability of commercial banks;
- more successful bank portfolio management;
- fostering economic development based on financing of cross-border projects;
- reducing systemic risk.
At first glance, achievement of the above goals seems contradictory or at least hardly feasible in the short or medium term. On the other hand, my proposal may contribute to the achievement of the above goals in cooperation with Western European countries. If we take the example of Bosnia and Herzegovina, we can identify one of the main systemic problems. From 2000 to-date, commercial banks in Bosnia and Herzegovina have been keeping excess mandatory reserves in their accounts. These excess reserves have grown over time only to reach between 90% and 110% of mandatory reserve amounts in the last two years. Lately, the Central Bank of Bosnia and Herzegovina has been paying interest to commercial banks on the excess reserves at a money market euro deposit rate payable up to one month (and, in some periods, at an interest rate equal to the overnight rate for interbank lending in the euro zone).

In other words, commercial banks incur significant opportunity costs of keeping excess reserves in the accounts with the Central Bank as a "sacrifice" for avoiding liquidity risk. In this context, Bosnia and Herzegovina is faced with a problem of hyper-liquid banks, on the one hand, and real sector illiquidity, on the other. The government does not issue securities to finance development projects. According to the law, the Central Bank of Bosnia and Herzegovina is not allowed to issue its own securities. Hence, there is no risk-free reference rate in Bosnia and Herzegovina to serve as a basis for bank portfolio structuring/restructuring. Governments of other Western Balkan countries issue securities denominated in national currencies, but due to a proportionately high level of political and institutional risk, the cost of financing public debt is above the average for countries that their respective national currencies are formally or informally pegged to (euro zone).

Great development potential is available in the Western Balkan region in terms of road, railway and energy infrastructure at cross-border level. Unfortunately, this potential is idle. Regional infrastructural development projects could help significantly reduce differences in economic development between the Western Balkans and European Union. Financing of such projects through issuance of government bonds denominated in national currencies and with a maturity period of 10 to 15 years could help upgrade regional economic cooperation and shrink the gap in economic development. In order to reduce the cost of financing capital investment by issuing government bonds to finance cross-border projects it would be necessary to increase the level of trust of financial investors in such assets and to reduce the required return.

New financial instruments of better quality, risk-free (or the least risky), capable of boosting profitability (reducing the need for keeping significant excess reserves) of commercial banks and of prompting faster economic growth and development of the Western Balkans, would have to be of such a kind as to ensure a lower level of systemic risk. In other words, issuance of Western Balkan government bonds should be supported i.e. insured. Who could influence reduction of the required rate of return on such bonds, while making these financial instruments more attractive?
My proposal refers to the issuance of Euro-Balkan Bonds. These bonds would be given that name because their issuance would be covered by guarantees of a new fund - the EU Guarantee Fund for the Western Balkans. Thus, the new fund would be established by the European Union/European Commission. Its main goal would be to offer guarantees for the issuance of government bonds of Western Balkan countries with a view to financing or co-financing infrastructural development projects. Priority would be awarded to cross-border infrastructural development project on PPP basis (public-private partnership projects).

The issuance of such bonds and their purchase by commercial banks dominating the Western Balkans would enable a more successful portfolio management. The interest rate would be tied to average interest rates on government bonds with the same maturity as in the euro zone, augmented by a risk premium for the region. However, the risk premium would be lower than the current one, which is included in the price of government securities issued by Western Balkan countries, because their issuance would be covered by the guarantees of the EBF (Euro-Balkan Fund). The Guarantee Fund would have a debt-equity swap option for state-owned infrastructure companies, whose equity would be pledged as collateral.

This proposal will certainly face a series of opposing arguments, partly because of the existing problems in the euro zone and intensive discussions on how to bail out unruly euro zone members. Nevertheless, these problems must be dealt with simultaneously in Western Europe and in the Western Balkans. The sooner we deal with them, the better. A belated reaction may be too late. The main weaknesses of my proposal include the following:

- the current political situation in the region is unfavourable for the implementation of this proposal;
- the current political situation in European Union member states may result in their unwillingness to support such a proposal or similar proposals;
- ethnically-based way of thinking about economic reforms in the region;
- the current capital market in the region is uncoordinated and fragmented;
- spillover effects of the financial and economic crisis and lower projections of economic growth in the countries of the region for the current year and next year; and
- the existing administrative barriers to doing business in the region.

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6I first present the idea of Euro-Balkan Bonds at a workshop held in Dijon, France, on May 10th, 2010, which was organized by the Association Bourgogne Balkan Express. The workshop materials were published in: "Accession of the Western Balkans to the EU: Evaluating a process", Sciences Po Paris, Paris, June 2010. The document is available at: http://ec.europa.eu/enlargement/pdf/publication/20100609_att4639135.pdf
On the other hand, some advantages and opportunities arising from my proposal include the following:

- a funding source based on such instruments is more reliable thanks to its guarantee schemes;
- interest rates on these new bonds would be lower thanks to EU guarantees, as compared to “classical” local bonds;
- implementation of cross-border infrastructural projects funded with these instruments would enable achievement of higher economic growth rates and provide faster regional connection of companies;
- fiscal sustainability would be a result of new jobs created through these projects and a result of regional connection of companies;
- the quality of financial instruments traded at regional stock exchanges would be upgraded, which would, in turn, improve portfolio management of financial institutions and help keep some part of the current money outflows to Western European countries within the region;
- foreign financial investors would also be more motivated to invest in the region;
- transaction costs would be lower, provided that stock exchanges in the region are connected into a single Western Balkan electronic stock exchange;
- all of this would result in an increase of market capitalization at the stock exchanges in the region, including an increase of funding sources.

The advantages of this proposal exceed its weaknesses. The current political and economic situation is very difficult and dangerous – not only in the Western Balkans. The amount of funds needed for the Guarantee Fund for the Western Balkans would not exceed 5 to 7 per cent of the existing guarantee schemes in the euro zone. To keep labour from the Western Balkans in their own countries of residence, as new jobs would be created through the implementation of cross-border projects funded by bonds covered by guarantees of the Western Balkan Fund, would be a much better choice (both in economic and political terms) for both sides - the European Union and Western Balkans - than just leaving the Western Balkans to deal with the crisis on its own. That feeling of being abandoned and left “to one’s own devices” may have far-reaching negative consequences for all of us. The Western Balkan region has plenty of natural resources and boasts a rather high level of human capital (all countries in the region have been ranked by UNDP in the group of countries with high level of human capital). Western Europe, on the other hand, is overpopulated and its resources are depleting. The size of the Western Balkans approximately matches the size of Great Britain, but its population size is only 35% of that in Great Britain. A comparison with the Netherlands is probably even more illustrative. The future of sustainable economic development largely depends on cost-effective spatial management, sources of good quality of drinking water and biodiversity. Short distances in the Western Balkans, as opposed to long distances in Western Europe, make this part of Europe very close and highly promising. The cost of a missed opportunity might be very high for both parts of Europe.
About the author

Fikret Causevic was born in 1963 in Bihac, Bosnia and Herzegovina. He took his master degree in 1995 and PhD degree in 2003 at the School of Economics and Business, University of Sarajevo. From 1989 to 2006 he worked at Sarajevo Institute of Economics and he was Deputy Director of the Institute from 1999 to 2006. Since 2008 Fikret has been Associate Professor at the School of Economics and Business, University of Sarajevo. He teaches courses on Economics, International Finance and International Banking at the undergraduate and graduate studies. From 2002 to 2010 he was a Visiting Fellow under the South East Europe Faculty Development Programme at the London School of Economics and Political Science – LSE Global Governance (Centre for the Study of Global Governance). He is a member of the GDN – Global Development Network (the World Bank), and the SEERN – the South East Europe Research Network.

Since 2008 he has been associated fellow of two centres of the Academy of Sciences and Arts of Bosnia and Herzegovina – the Centre for Social Sciences and the Centre for Systemic Research. Since 2003 he has published five monographs and two books. International edition of his „Economic Sovereignty and Global Capital Flows“ was published by Hyderabad University Press in October 2008. In addition to publications in the fields of international finance, financial markets and institutions, his main areas of interest as a researcher have been the labour market, fiscal policy, and monetary policy. In June 2009, the Presidency of Bosnia and Herzegovina elected him a member of the Governing Board of the Central Bank of Bosnia and Herzegovina. In May 2011, the Governing Body of St Antony’s College elected Dr Causevic to the Alpha Bank Visiting Fellowship for the academic year 2011/2012.

The views expressed in this paper are solely those of the author’s.

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- To spearhead intellectual exchanges and debate on these issues among networks of individuals and institutions beyond Oxford;
- To foster cooperation between the academic and the policy making communities.