South East European Studies
at Oxford

workshop report

South East Europe: Pre-requisites for reform

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South East European Studies at Oxford
CELEBRATING 10 YEARS 2002—2012

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Bank of Albania – SEESOX High-Level Seminar

This report draws on discussions at the high-level seminar on "South East Europe: Prerequisites for Reform", which was held in Tirana, Albania on 14th June, 2012. The seminar was jointly organised by the Bank of Albania and SEESOX. The participants were academics, officials and political figures from South-East Europe, the UK and elsewhere, as well as experts from the EBRD and the IMF. The report represents SEESOX's interpretation of presentations and discussion during the seminar.

Overview

The seminar took place in the context of the continuing uncertainty about the outlook for growth and financial stability in the euro area. The prospect of imminent elections in Greece, with one of the leading parties opposed to maintaining the austerity program agreed with the "Troika" (IMF, EU and ECB), gave the discussants an alarming sense of being at a potentially decisive yet unpalatable fork in the road. Would the Eurozone break up, with unknown and potentially catastrophic consequences for neighbouring regions as well as for financial centres around the world? Or would the Eurozone stagger on without a clear solution to the crisis, dragging down growth globally and especially in Europe? The discussions began on the overarching question of how policies in the region should respond to this dilemma, and then narrowed the focus onto the more specific questions of how to provide for adequate fiscal space to facilitate reform, and on the political prerequisites for reform.[1]

Participants were provided with a sobering assessment of the adverse global environment which countries in Southeast Europe continued to face. This was delaying a much needed recovery in the region. Political appetite for reform was weakening, even while the need for reform was growing. Participants nevertheless felt that the momentum for reform should not be lost. There were important lessons to be learnt from the build up to the crisis in the region, especially the failure to appreciate at the time that the very rapid growth rates observed through to 2007—driven in part by capital inflows from Western Europe—were well above long run potential. Fiscal balances had been flattered by unsustainable

[1] In the event, elections in Greece took place two days after the conclusion of the seminar and resulted in a new coalition which remained committed to the program agreed with the Troika. The path of continuing uncertainty regarding the future of the Eurozone was therefore by default selected.

revenues. Excessive government spending led to the emergence of yawning fiscal chasms when the crisis struck and revenues collapsed. This pointed to a need to strengthen fiscal institutions in the region in order to achieve better fiscal management and to avoid similar problems in the future. Fiscal institutions were, however, only as good as the staff that served them and the political support they received. Institution building must therefore be complemented by a restoration of political will for reform and by the education of the public on the need for reform.

Strengthening domestic anchors

The first session was opened by two of the most senior policy makers in Albania. *Governor Fullani* (Bank of Albania) drew attention to the now acute nature of the crisis in the Eurozone. The burden of sovereign debt in the peripheral members, the limited ability of the Eurozone as a whole to absorb further risk, and the continued deleveraging of the financial sector was progressively undermining confidence about public sector financing and macroeconomic stability throughout the system. For South-East Europe, with close trade and financial links with the Eurozone, concerns were growing for both short and long term economic prospects. With adjustment and retrenchment programs initiated in the region relatively early in the global financial meltdown, the eruption and prolongation of the Eurozone sovereign debt dimension of the global crisis—right on the region's doorstep—was delaying an overdue recovery and sapping enthusiasm for much needed reforms. Governor Fullani noted the desire of all countries in the region to further the process of their integration with the European Union (EU). External anchors could not, however, support long term stability if domestic anchors were absent. Reliance on external anchors alone has therefore been disappointing. He welcomed the seminar as an opportunity to learn lessons from recent experience and to explore the scope for reforming and strengthening domestic anchors, particularly fiscal anchors. *Minister of Finance Bode* (Ministry of Finance, Albania) shared many of the concerns raised above, and stressed the urgency of reforms in the region. He noted that it was Albania's willingness to undertake far-reaching reforms during 2005-7 that has helped the country withstand the repeated shockwaves of the financial crisis—which he characterized as a journey through a valley of hell—and has enabled it to be one of the very few countries in Europe which has so far avoided recession.

The Governors roundtable discussion was led by representatives from five regional Central Banks—Albania, Kosovo, Macedonia, Serbia and Turkey. Each reflected on the lessons from their own national experiences. *Governor Žugić* (Central Bank of Montenegro) observed that in the wake of the crisis there will likely be a shift in the emphasis of central bank policies towards securing financial stability, in place of the exclusive focus on price stability that had been the fashion since the mid-1990s. With more than one objective, monetary authorities would need to look beyond interest rates alone as their controlling instrument, and seek to manage the liquidity and solvency of the financial system by expanding their monetary and regulatory tools. Regional cooperation becomes especially important where bank branches in many countries share the same foreign parent (the Vienna initiative being a good example). *Governor Gërguri* (Central Bank of Kosovo) reiterated the need for regional cooperation, and noted that this should have a broad scope, including a regional infrastructure for investment, a regional policy on foreign direct investment, and a regional capital market. He saw potential for the region to act as a gateway to Europe for the Middle East and Asia. *Vice Governor Angelovska-Bežoska* (National Bank of the Republic of Macedonia) noted that public debt ratios in many countries in the region had started to reach worrying levels, well above the 25-40 percent (of GDP) ceilings recommended for transition economies. External debt was rising, while net international positions were also above the negative 35 percent (of GDP) level she saw as the safety threshold. Sound fiscal policies were therefore required to decrease external exposure. An aging population meanwhile presented problems for fiscal solvency over the medium to long term. These considerations pointed to a need for fiscal retrenchment, which should be gradual in view of the prevailing weakness in the regional economy and clearly justified and explained to the public to ensure political acceptance. She also stressed the need to improve fiscal institutions—for example, through medium term budgeting, performance budgets and better commitment control. *Deputy Governor Kenç* (Central Bank of the Republic of Turkey) painted a gloomy picture of the Eurozone, which he felt was still a long way from addressing the core issues at stake—the lack of sufficient fiscal solidarity for a monetary union, the absence of a convincing growth strategy, and a broken bank business model. Against this depressing backdrop, the experience of Turkey in 2000-02 suggested that recovery policies in the region could usefully focus on diversifying the region's trade and funding channels, while managing expectations in a positive way. Governor Fullani reprised the theme of the common ambition for countries in the region to integrate with the EU, but stressed that it was imperative that countries seek convergence before entering the EU rather than afterwards, lest they fall into the Greek trap.

Fiscal space for reforms

In the afternoon, the focus of the seminar was narrowed to the question of fiscal space in the region. *Mr Backé* (Oesterreichische Nationalbank) presented the findings of a recently published paper discussing fiscal space in Central, Eastern and South-eastern Europe (CESEE).[2] The notion of fiscal space he examined was the capability of fiscal policy makers to properly respond to a business cycle shock. Mr Backé observed that in the pre-crisis boom period, discretionary fiscal policy had been expansionary in many countries

[2] *Limited Fiscal Space in CESEE: The Issue, Underlying Economic Conditions, Related Implications and Policy Options*, by Markus Eller, Peter Mooslechner, and Doris Ritzberger-Grunwald, Oesterreichische Nationalbank (OeNB), Proceedings of OeNB Workshops No. 17, February 2011.

in the region. The cyclically adjusted fiscal balance was substantially more negative than it appeared at the time. He accepted that it may have been difficult to accurately calibrate the cyclically adjusted balance in countries going through such a rapid economic transition. But the reality was that political pressure in the new democracies made it hard to resist demands to increase spending when the resources appeared to be available. When the crisis struck, the headline fiscal balance swung dramatically into deficit. This reflected a much sharper than expected decline in revenues as output and incomes fell. From such an unpromising underlying fiscal position, there was very little scope for discretionary fiscal measures to offset the recession—capital markets were in no appetite for a further increase in deficit financing.

While public debt levels were relatively low by the standards of the larger industrial countries, market tolerance for higher levels of debt in emerging economies in the region was also correspondingly lower, especially in situations where private debt levels were also worryingly high. At the same time, financing conditions deteriorated markedly, with risk premiums (e.g., as measured by credit default swaps) rocketing towards the end of 2008 and early 2009. With the supply of capital drying up, a number of countries in the region had little choice but to seek exceptional financing from the IMF and the EU.

The sharp rise in risk premia reflected the lack of credibility in fiscal policy, in part reflecting the poor track record of policy implementation even in the pre-crisis years. Mr Backé concluded his discussion by recommending that countries in the region could improve their chances of building fiscal space (and thereby mitigating the next crisis in years to come) by stepping up reforms of fiscal governance and exploring the scope for adopting—and adhering to—fiscal rules. Improvements in managing the liability structure of public debt, both by lengthening maturities and shifting the currency composition towards local currency denomination would also help.

The potential role of budget institutions in facilitating budget consolidation in South-eastern European countries was further explored in a paper presented by *Mr Olden* (International Monetary Fund).[3] This paper listed three principal challenges that fiscal authorities must be able to handle when responding to a fiscal shock: (a) understanding the scale and scope of the shock, (b) developing a credible fiscal consolidation strategy, and (c) implementing that strategy through the budget process. For these three challenges, ten budgetary institutions are identified that would help the fiscal authorities address them. To better understand the scale of the task, there needs to be: (i) accurate fiscal outcome reporting, (ii) skilled macroeconomic and fiscal forecasting, and (iii) systematic fiscal risk assessment and risk management plans. Development of a credible fiscal consolidation strategy requires: (iv) fiscal targets to be set over a medium term horizon, (v) the related

[3] *Fiscal Consolidation in Southeastern European Countries: The Role of Budget Institutions*, by Brian Olden, Duncan Last, Sami Yläoutinen, and Carla Sateriale, IMF Working Paper (WP/12/113), May 2012.

budgetary framework to have a similar medium term perspective, (vi) independent fiscal agencies to help set or at least vet the economic assumptions of the strategy as well as follow and report on its implementation, and (vii) performance budgeting that links funds to successful completion of programs rather than simply exhausting line items. Finally, budget implementation can be assisted by: (viii) top down budgeting that fixes aggregate and sectoral ceilings on spending, (ix) parliamentary approval of the budget, including the binding aggregate targets, and (x) discipline in budget execution that, inter alia, avoids open ended appropriations. Mr. Olden noted that there was persuasive empirical evidence from countries around the world that the strength of the above ten institutions in the fiscal process was correlated with successful budget consolidation.

The study contains a wealth of information about the prevalence of these ten institutions across countries in South-eastern Europe. On a scale of A to F, most countries had an overall score of C (moderately strong). Variation in institutional strength within countries was much greater than across countries. The most notable weak point was in the quality or existence of independent fiscal agencies. Overall, the score was not bad, but there was clearly room for improvement for all countries in the region.

Dr Škreb, as the podium's discussant of the two presentations, invoked the concept of negative fiscal space, reflecting his concern that many countries were still struggling to escape this zone. While he lauded the efforts to improve institutions, he questioned whether we could assume that there were any ideal institutions or rules when politics could still exert a perverse influence. While there had been some success in shielding central banks from political interference by making them independent under the law, it was much harder to do this for fiscal institutions because fiscal policy is by its nature political. Comments from the floor generally endorsed the efforts to strengthen fiscal institutions and rules, but cautioned that such arrangements were not infallible.

Attitudes to reform: the citizens' perspective

The final session considered the broader question of political support for reforms, especially from the perspective of the population at large. *Dr Sanfey* (European Bank for Reconstruction and Development) drew on the EBRD's about-to-be-published survey of *Life in Transition* to illustrate the changing attitudes to reform of the citizens of the EBRD's client members (including many countries in Southeast Europe).[4] The study showed that conventional economic measures such as GDP and employment significantly understated the true adverse impact of the crisis on the perceived well being of individuals. Moreover, this was especially the case for countries in Southeast Europe compared with other transition countries. Relative to the previously published survey undertaken in 2006 a slight weakening of support for democracy and the market economy was evident, but this indicated more a greater sense of apathy and scepticism rather

[4] *Life in Transition: After the crisis*, European Bank for Reconstruction and Development, June 2012.

than a desire to go back to autocracy and central planning. More remarkable was the observed decline in respect for political institutions. This was going to make it harder for politicians in South East Europe to get buy-in for reforms.

Dr Anastasakis (SEESOX), the discussant on the podium, added to this somewhat discomforting finding by noting that a powerful beacon for reform in the region had hitherto been the prospect of EU and Eurozone membership—now no longer such an attractive scenario and likely to be more protracted. When growth was strong and there was a lot of foreign direct investment, people were more amenable to reform than now when both things were in short supply. Populist governments were gaining ground and this was not good for reform. He concluded by stressing that social concerns should be taken into account in policy making, in order to avoid social frustrations and the disintegration of the social fabric.

Mr Watson (SEESOX) summed up the day-long seminar by drawing on an analogy made by Governor Fullani about there being as much smoke and noise as actual fire afflicting the global economy (especially coming from the Eurozone), and observed that more people die of smoke (i.e. uncertainty) than fire. He noted the finding that support for reform in the region was slipping and that confidence in the growth model that has driven transition to date has weakened. While there was no obvious substitute for the existing growth model, it was not clear where growth was going to come from in the short term, in view of the limited scope for central banks to stimulate growth in the prevailing circumstances and the lack of fiscal space. Pending a global recovery, there could, however, be scope for growth prospects to be enhanced by better linkages and cooperation between countries in the region. Looking forward, fiscal rules and institutions could be strengthened, but politicians (and their constituents) needed to be appropriately educated to implement and respect them.

Participants

Othon Anastasakis	Director of SEESOX; Fellow of St Antony's College Oxford
Anita Angelovska-Bežoska	Vice Governor of National Bank of the Republic of Macedonia
Peter Backé	Deputy Head of Division Oesterreichische Nationalbank
Adam Bennett	Senior Member, St Antony's College Oxford
Ridvan Bode	Minister of Finance, Albania
Ardian Fullani	Governor, Bank of Albania
Gani Gërguri	Governor, Central Bank of Kosovo
Turalay Kenç	Deputy Governor, Central Bank of the Republic of Turkey
Brian Olden	Senior Economist, International Monetary Fund
Peter Sanfey	EBRD; Senior Member, St Antony's College
Marko Škreb (Chief	Economist, Privedna Banka Zagreb
Max Watson	Visiting Fellow of St Antony's College Oxford
Radoje Žugić	Governo, Central Bank of Montenegro

ABOUT SEESOX

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South East European Studies at Oxford (SEESOX) is part of the European Studies Centre at St Antony's College, Oxford. It focuses on the interdisciplinary study of the Balkans, Greece, Turkey and Cyprus. Drawing on the academic excellence of the University and an international network of associates, it conducts policy relevant research on the multifaceted transformations of the region in the 21st century. It follows closely conflict and post-conflict situations and analyses the historical and intellectual influences which have shaped perceptions and actions in the region. In Oxford's best tradition, the SEESOX team is committed to understanding the present through the *longue durée* and reflecting on the future through high quality scholarship.

SEESOX has the following objectives:

- To support high-quality teaching and research on South East Europe;
- To organise conferences, workshops and research seminars;
- To promote the multi-disciplinary study of the region within the University of Oxford (e.g. politics, international relations, anthropology, sociology, economics) working in collaboration with other Centres and Programmes within the University, including student societies;
- 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.

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