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EU CONVERGENCE: SOUTH EAST EUROPE SIX FACING MACROECONOMIC CHALLENGES

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Abstract

Coping with competitive pressures and market forces within the EU in the medium-term, the South East Europe Six (SEE6) needs to address important challenges through determined implementation of structural reforms. Progress with structural reforms can help for macroeconomic stability, for example, by reducing the structural external deficits. It helps nominal convergence too, as the productivity realizes the improvement of competitiveness and helps disinflation by maintaining low unit cost.

Also, the paper is focusing on periods of low inflation and deflationary pressures, when exchange rate anchors do not allow sufficient space for fiscal and monetary stimulus. In this respect, policy makers are under following dilemma: to deviate from exchange rate anchor and increase the space for fiscal and monetary stimulus; to accelerate structural reforms and competitiveness and on short run deepen the recession pressures; and to increase foreign debt and thus increase scope for fiscal and monetary stimulus while preserving the exchange rate anchor.

Key words:
EU, SEE6, Macedonia, convergence, reforms.

JEL classification: O11.

1. Introduction

Because of the fact that Southeast European countries rely mainly on exchange rate anchors to reduce inflation, the appreciation of the real exchange rate among countries in the region is significant, and it is slightly lower when compared to countries in the EU member states. As a result, these countries suffer from loss of competitiveness. This can be clearly seen from the movements of the deficit on their current account, which are important in all these countries. Using the exchange rate as anchor for inflationary expectations, on long run has been effective so far, producing a low and stable inflation rates. However, in periods of low inflation and deflationary pressures, exchange rate anchors do not allow sufficient space for fiscal and monetary stimulus. In this respect, policy makers are under following dilemma: to deviate

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from exchange rate anchor and increase the space for fiscal and monetary stimulus; to accelerate structural reforms and competitiveness and on short run deepen the recession pressures; and to increase foreign debt and thus increase scope for fiscal and monetary stimulus while preserving the exchange rate anchor.

Economic policies can be instrumental for growth in the short- and the medium-term in SEE6. On the fiscal side, sustained reform effort is needed to address structural rigidities in the budgets of SEE6. Priorities include: changes in the composition of public expenditure toward investment and away from wages, public expenditure targeting and prioritization as well as improvements in revenue collection and the broadening of the tax base, among others. On the monetary policy side, with regional inflation at a very low 1.2 percent and big output gaps remaining, some scope for short-term easing of monetary conditions exist, especially in those countries where deficits have begun to decline.

2. A Brief Review of Recent Changes

Acceding into the European Union (EU), countries are facing with macroeconomic challenges on their way to this membership. Countries should meet a number of economic, political and legal criteria. For countries in transition, formal economic criteria for accession are primarily focused on establishing a functioning market economy. The formal process for access puts more emphasis on progress of transition reforms in the early stages of accession, as countries struggle to establish market economies, while compliance with specific criteria for macroeconomic stability are prevailing in the later stages. Fulfillment of economic criteria, in fact, is real and nominal convergence. The progress with market reforms can be measured through various indicators of transition. These reforms are essential for improving real convergence or revenue growth to the level of the EU, which helps countries to advance the competitive pressures in the economic union (Bishev and Boshkov, 2015). Macroeconomic stability and nominal convergence of key macroeconomic indicators such as inflation and fiscal deficits to the EU levels, is also important for development and progress of a functioning market economy.

Referring to the macroeconomic stability and progress in the transition, both are closely related and important for sustainable growth and progress towards a functioning market economy. Progress with structural reforms can help for macroeconomic stability by reducing the structural external deficit. It also helps to nominal convergence, as productivity realizes the improvement of competitiveness and helps to disinflation by maintaining low unit cost. The challenge for the accession process is to realize a nominal and real convergence with macroeconomic stability and stable development. Further, this could be complicated by the need of facing with potential shocks as large and volatile capital flows and to finalize the transition to a market economy.

Like many countries in the early stages of transition, Southeast European countries rely mainly on the exchange rate to reduce inflation (DeBroeck, 2006). Aside from Albania, and Serbia, all other Southeast European countries have neither the currency nor the boards tightly controlled management or pegging for a specific time. Initially, inflation declined with the exchange rate, but increasing of external deficits prompted a move towards managing fluctuation in 2003 (Buiter, 2003). Inflation continued again,

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oppressed administrative prices were adjusted and growing euroisation contribute for increasment of foreign currency-exchange rate shift to the prices. Moving of the regime may hit the credibility of monetary policy adversely, as it is shown through growing euroisation. The drivers were less successful in reducing external imbalances, suggesting trade off with inflation. Although large fiscal deficits can contribute for external imbalances in some countries (Croatia). They also reflect the slow progress in reforming the real economy. The largest current account deficit is among the countries with the most progress on structural reforms (Serbia, Montenegro, Bosnia and Macedonia), which are measured with the same transition indicators or the share of private sector in GDP. This confirms that nominal convergence and macroeconomic stability are closely connected with real convergence and the introduction of market economy.

3. Theoretical Notes and Reality

Exchange rate as fundament and slow structural reforms put pressure on competitiveness (Oskooee 2001). Fixed or nearly fixed exchange rate could lead to unsustainable real appreciation and loss of competitiveness, unless fiscal and income policy remain closely tied and structural reforms increase productivity. For example, in Serbia, the exchange rate in 2002 became unsustainable as real wages grew up and external deficit increased. Pressure for real appreciation in the region is also growing due to large inflows of foreign currency. The sustainability of the exchange rate in Southeast Europe in particular will depend on the accompanying policies. So far, the slow progress of structural reform in many of these economies increases the risks associated with soft pegging. Competitiveness can also be torn over time through a lack of fiscal discipline or weak-income policies. In Serbia and Macedonia, where fiscal policy is tight, exchange rate as fundament can become problematic if competitiveness is lost. This can happen if income policies are also lost or structural reforms fail to boost productivity. Croatia, which has significant fiscal deficits and exchange rate as an anchor may also face with problems of competitiveness over time. This can be activated if the currency inflows to the tourism sector or strong capital inflow leads to real appreciation, with opposite effects on other sectors of traded goods. Any move toward more flexible arrangements in Southeast Europe should be carefully considered to avoid market distortions successfully.Various indicators show that the economies of Albania, Bosnia, Macedonia, Serbia and Montenegro need more progress in transition reforms to become functioning market economies, a key criterion used by EU for moving the countries from one phase of the approach to another. Slow structural reform is also reflected through low levels of FDI and this may limit the potential for growth in the medium term - or real convergence. Slow structural reform also affects macroeconomic stability, which is the core of large external imbalances in some countries. Especially in Bosnia and Serbia, large current account deficit reflects low level of competitive exports, while imports is increased by foreign remittances, strong credit growth or potential flexibility of required management.

4. Regime Diversity and Reforms

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Macroeconomic challenges in other countries of Southeastern Europe are related with viability of their monetary framework, risks of rapid financial deepening and future fiscal consolidation in supporting growth and stabilization. Many current actors for exchange rate may not be sustainable over the whole time, unless if they are better supported by fiscal consolidation and structural reforms. Also, various indicators haven't show a clear sign of problems with the competitiveness of these countries now. Large external deficit and weak supportive policies in some countries may increase these risks over time. The shift towards more flexible monetary framework is complicated by high euroisation, resulting in weak monetary transmission mechanism. In future, this underlines the need for fiscal consolidation and increased flexibility of fiscal policy in responding to the shocks as the need for structural reforms in lowering external imbalance too. Rapid credit growth, especially in foreign currency, add further pressure on the external balance and inflatory dynamic in many countries. This is challenging supervisory capacity in mitigating the risks in the financial sector. Most South-east European countries have "space" to reduce public spending and to increase the share of growing consumption. A lower deficit will increase private sector, leading to growth as it facilitates macroeconomic management too. Also growth will increase by reducing high taxes on labor in many countries. But the biggest fiscal adjustment blow should come by reducing bigger salaries in the public sector, subsidiary and transfers.

Exchange rate regimes in the region are different, ranging from currency board in Bosnia and Herzegovina to almost free fluctuation without inflationary targeting in Serbia. The common is that due the transition process these countries have dedicated special attention to their exchange rate regime and most of them used fixed exchange rates, reflecting their large trade openness and their efforts to set up a strong monetary authority. Regardless the exchange rate regime, the appreciation of the real exchange rate of the countries in the region is significant, though slightly lower when it is compared with the EU Member States. As a result, these countries also suffer from a competitive loss. This can be clearly seen from the movements of the deficit in the current account, which is important in all these countries. For example, current account deficits in 2007 ranged from 3.1% of GDP in Macedonia to 36.2% of GDP in Montenegro.

Using the exchange rate as the hope for inflation expectations have been effective until now, producing low and stable inflation rates (Goswami, 2011). In terms of high import dependence and relatively slow implementation of structural reforms realized in increased export potential, contributed to the importance of high trade deficit, was mainly financed by higher private transfers. The transition process in Macedonia is specific because of the relatively slower process of real convergence and continuing real depreciation of the Macedonian Denar (Bishev and Boskov, 2015) .In many cases productivity in the tradable sector is compared with growth of foreign partners with relative lower rates (Loko and Tuladhar 2005). This was due to the absence of large foreign companies and loss of important foreign markets, especially after independence. In such conditions, the only way to maintain the competitiveness of macedonian producers was the specialization and exports of lower quality products. These developments have generated inflationary pressures, which caused absence of real appreciation that was evident in other transition

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countries. In the past few years, Macedonia moves quickly and closer to the more advanced transition economies. As regards nominal convergence in the context of European Union integration, Macedonia faces with challenges which are common to the most economies in the region and beyond. Since 2007, there has been acceleration of the inflation rate, which is mostly caused by the global price rise of food and energy. Thus, uncertainty in the movements of these prices, and expectations of pressure caused by the process of real convergence, are the main challenges for monetary policy in the medium term.

5. Macroeconomic Achievements of SEE6

The SEE6 countries exited from recession in 2013 with economic growth supported by the recovery in high-income countries, particularly those in the European Union (EU) (NBRM 2013). External demand for SEE6 exports was the key driver of this growth recovery, reflecting an improving European and global economy. An export-led recovery combined with depressed domestic demand resulted in a significant narrowing of current account imbalances in all SEE6 countries.

Economic policies can be instrumental for growth in the near- and the medium-term in SEE6. On the fiscal side, sustained reform effort is needed to address structural rigidities in the budgets of SEE6. Priorities include:

- Changes in the composition of public expenditure toward investment and away from wages;
- Public expenditure targeting and prioritization, as well as
- Improvements in revenue collection and the broadening of the tax base, among others.

On the monetary policy side, with regional inflation at a very low 1.2 percent and big output gaps remaining, some scope for short-term easing of monetary conditions exist, especially in those countries where deficits have begun to decline (European Commission 2014).

However, caution needs to be exercised in the economies with flexible exchange rates to ensure that these do not come under pressure. In terms of financial sector policies, addressing the high NPLs would be critical to ultimately restoring the growth of credit and supporting entrepreneurship and job creation. The region that provides greater long-term rate of real economic growth, and sustainable GDP growth based on profitable production with sufficient export content has a better chance of attracting foreign capital. Namely, international investors rightly expect to achieve high rates of return on invested capital in that region enjoying long-term sustainable economic growth. Thus, the trend of the movement of the real exchange rate euro/dollar mostly affect the sustainable rate of real economic growth, which is associated with net capital flows. Financial stability and the efficient allocation of macroeconomic level appear in each economy as an indirect product of successful political coordination. Variables such loans, the cost of funds and the real exchange rate are not aim of any instrument; transparency limits the extent to which they could be involved in decisions. The experiences of this region confirmed that alternative monetary

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and fiscal regimes, giving adequate political support, can provide very well low inflation. Much more difficult for assessment are the risk characteristics of the regimes.

What can be concluded from the first aspect of the monetary framework which is best suited for managing the real and nominal convergence on the road to the euro, starts exactly from the view that inflation targets seem to have a better set of available tools than those that peg for managing the process of convergence with balance towards adopting the euro.The main risk for targeters are excessive fluctuations in exchange rates, but if the policies are aimed at macroeconomic stability, the probability to make this reality is reduced. Then, the possibility danger is excessive appreciation of the nominal exchange rate, which is likely to lead the country toward expensive interventions or reduction of domestic interest rate that could fuel a credit boom. Options are limited for those who peg.

6. Adoption of the Euro in the Republic of Macedonia

As part of the EU accession, from Macedonia is expected to adopt the euro as its currency some time after the accession. The time for accession to the euro depends of two factors: is the country able to meet the necessary conditions and where the benefits of EU membership outweigh the costs (Buiter and Grafe 2002).

Macedonia appears to be relatively well positioned in bidding early entry into the EU as long as its macroeconomic policy can withstand the shocks to join into the EU. The adoption of the euro should promote increased trade volume with other members of the eurozone (Schadler 2004). Considering the size of Macedonia and dependence of the trade volume, trade expansion should be seen as an important benefit of the adoption of the euro. Therefore, Macedonia expects capital inflows, including more FDI, even before the adoption of the euro; there will appear political challenge in the short term as benefit in the long run too. As a small country, Macedonia has limited room for independent monetary policy. The standard arguments for optimum currency area in view of the importance of synchronization of shocks among the members has some validity, but many transition economies that once were joined into the EU didn’t experience a strong correlation of the shocks (Schadler 2005). Thus, the argument that appears is to be relatively early adoption of the euro if the process can be well managed. In doing so, this implies to the decisions on exchange rate policy and strong macroeconomic management. What kind of regime is needed to follow before or after accession depends of a certain part on how quickly the new Member States wishing to adopt the euro as its currency. The experience of the new EU Member States in terms of their choice of exchange rate is limited on two regimes: it can be called highly pegging, including the currency board arrangement and a floating exchange rate with monetary policy based on inflation targeting. The most advanced Member States have decided for a flexible regime and inflation targeting, while those with a higher volume of real convergence should begin to realize, such as Bulgaria and the Baltic countries, which opted for a strong pegging.

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In the past few years, Macedonia rapidly moves closer to the more advanced transition economies. Several years in a row there is positive and stable growth rate. Although economic growth rates are lower compared to those of the Baltic countries, and in some countries in the region, this is a sure sign of acceleration of the process of real convergence. This process is also supported by FDI and portfolio investment as rapid credit expansion too (Hochreiter and Tavlas 2004).

Regarding nominal convergence, Macedonia is facing with challenges that are common for the most economies in the region and beyond. Thus, uncertainty regarding the movements of prices and expectations of pressure caused by the process of real convergence, are the main challenges for monetary policy in the medium term. Further, Macedonia is facing with significant transition challenges and only through effective decision of these challenges the country will be able successfully to compete on the EU market. To formulate effective policy, it is necessary researching of the growth of total factor productivity in Macedonia as well as the reasons for low business investment. Macedonia's membership in the EU can improve the industrial situation only if access to a large extent makes Macedonia location from which foreign investors can serve to the EU market. This means that the domestic industry, with FDI must make the necessary changes to its output. These long-term structural shifts in employment and output, can be accelerated through the accession of Macedonia to the EU, i.e. sectoral change can be an important driver of change in aggregate factor productivity and income of workers in different sectors of the economy.

Given the large gap in price and income per capita between Macedonia and the EU, price accepting will be an important source of inflationary pressure, as it faces the existing price distortions in the energy, municipal services, etc. Before accession it can move this factor as inflationary engine around the time of access where the effect of real convergence on inflation is combined with negative short-term effects of EU accession on fiscal balance, falling interest rates and so on. This will require careful management of the exchange rate. This means that, if the Macedonian real growth accelerates, Macedonia will be more attractive candidate for EU membership, but it will face with more intensive pressures to the exchange rate regime and macroeconomic policies. Labor, capital and product market, all these are transmitters of the monetary and fiscal policy, i.e. creation of a functioning and flexible markets is important, not only in terms of meeting demand competitive single market but in terms of creating a more effective government macroeconomic policy. Regarding Republic of Macedonia, it is important to keep in mind that the economic policies and reforms should be consistent with the reforms and policies of convergence and integration with the EU, as long-term strategy.

So, in future, exchange rates can be seen not only as an instrument for maintaining price stability in Macedonia, but also as a tool that will contribute to the economic stability of Macedonia, strengthening the stability of the financial system and supporting for fast convergence meaning accession to the EU.

7. Conclusion

The role of the exchange rate as a nominal anchor derives from the characteristics of the domestic economy, as a small and open economy that is highly dependent on the import of primary commodities.

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According this, Macedonian exchange rate can be used as an instrument for export performances of the country and macedonian policymakers should create policy with several aims focused on exchange rate policy.

Boosting incomes in the medium to longterm with the aim of converging with EU standards will mean not only maintaining the pace of reforms—but also converting reforms benefits into robust and equitable economic growth. Both of these are proving challenging. The reform pace appears to have slowed during the financial crises. Countries will need to take advantage of the economic rebound to relaunch the reform and convergence processes. There is evidence suggesting that improvements in the business climate should be broad rather than targeted toward specific sectors, as growth and employment creating firms tend to be young and dynamic, but not concentrated in any particular sector. Improving trade links in terms of logistics, institutions and regulations will be important to take advantage of the EU market. In addition, governments need to provide reliable and streamlined processes that guarantee EU safety standards are met for exporting firms, particularly for agricultural exporters. Improvements in governance standards—including the rule of law—will be closely linked to the EU integration process. But reforms required by the EU will also help to boost economic growth in SEE countries. Such reforms are essential to boost labor demand, reduce unemployment, address the challenges driven by demographic changes and improve prosperity for all in SEE6. Increasing employment is essential to reduce poverty and to bring about shared prosperity in SEE6. Since the major source of income for most households is through selling labor, increasing employment opportunities and ensuring that workers have the skills necessary to take advantage of these opportunities are essential to increase the income generation capacity of the entire population.

The researches offer options that include increase of the labor contribution to economic growth by raising labor participation and reducing unemployment (Srinivasan and Archana, 2011).The second options means improvement of allocative efficiency. This understands promotion enterprise restructuring and reforming product market regulation as including regulation in the infrastructure sector. Next options are focused on deepening trade integration by promoting export-oriented FDI and developing the supply of exportable goods, meaning that Macedonia would need to integrate its logistics infrastructure. Accelerating the process of economic convergence to EU will be supported by fostering technological progress. The recommendations are focused on policy-makers, inviting them to identify what policies are politically feasible and to be checked for their consistency with the overall objective of raising and sustaining economic growth. Next, these strategies need to generate institutional requirements that are commensurate with the existing institutional endowment of Macedonia. This will lead to a near-term focus on deepening trade integration and fostering innovation, while measures related to expanding labor participation and employment could be adopted more gradually with a long-term perspective (Srinivasan and Archana, 2011). These measures would better position the country to fully benefit from EU Accession and to better manage the effects of the global financial crisis, by strengthening Macedonia‘s international competitiveness.

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