Models for Stability and Growth, Structural Reforms, Conditionality, and EU Surveillance Criteria

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Abstract
Policy frameworks of the IMF, the World Bank, and the EU are discussed in order to come up with criteria of macroeconomic and financial stability and sustainability for Future Member States of the EU (candidate and potential candidate countries). The key deficiency of the EU policy framework is that it lacks short term stabilization policy model and instruments for adjustment, like e.g. the IMF. It also lacks an appropriate model for investment support, though not necessarily the funds if not the instruments. The paper suggests a set of criteria for surveillance.

This paper represents the policy part of the report on financial risks in Southeast Europe.

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Introduction

The aim of this paper is to propose a set of surveillance mechanisms and criteria that European Union (EU) could use to assess the stability and sustainability of economic progress of the Future Member States (FMS). Those should identify risks and vulnerabilities, primarily the financial ones. The key issue of this exercise, however, is to determine the objects, goals, or targets that the monitoring of indicators of vulnerability should aim at. With that in mind, a somewhat general discussion of different approaches to advising or supporting the policy making will be given at the beginning. To highlight the issue and outline answers, the frameworks of the International Financial Institutions (IFI: primarily the International Monetary Fund, IMF, and the World Bank) will then be surveyed. First, the model used by the IMF for short term financial programming for macroeconomic stability will be discussed and its consistency with the current policy innovations in the IMF will be considered. In addition, the World Bank model that targets growth will be described shortly. Then, an alternative framework for the EU’s engagement with the FMS will be developed. The paper ends with a discussion of the set of surveillance criteria that the EU may want to adopt.

Targets and instruments: three approaches to policy design

There are basically three distinct approaches to influencing the policy design, by policy advice or by policy support. In the case of the IFIs, though not necessarily in the case of other multilateral institutions, an approach to policy design, financial support and advising is adopted that can be called Keynesian. There are two other approaches that can also prove to be appropriate for the particular relationship that the EU has or could have with the FMS: the more modest Weberian one and the more comprehensive approach of public choice. Policy design is about choosing goals or targets and attaching means or instruments to them. In the Weberian approach, which follows from the practical philosophy of Hume, Kant and Mill, goals or targets are chosen by the policy makers (or individuals or other actors that can be instrumentally rational). The basic premise is that of Hume’s divorce of the normative from the positive: is does not imply ought. Put simply, the fact that something can be done does not mean that it should be done. Why something should be done is to be decided by the decision maker. No advice or other type of support, short of coercion, is needed, or can be reasonably expected to be useful, for the choice of ends, goals, aims or targets (this is akin to assuming a

1 This are candidate and potential candidate countries, i.e. Western Balkan countries and Turkey.
preference or some other welfare or objective function for the decision makers). However, as a rule, a goal can be realised or a target can be reached in a number of different ways, thus implying the possibility of choice of action. In the assessment of the feasibility, the efficiency and the economy of a certain means or an instrument or in the determination of the trade-off between different instruments given the chosen target – advice or other type of support can play a role. In the Weberian approach to policy sciences, that is all that an expert advice or outside influence of any kind can do. The general form is that of instrumental rationality: if you want x, do y. Thus, the policy task is:

Weberian policy (technocratic): Given the target, choose an instrument (e.g. that is most efficient or satisfies some other appropriate criteria).

This approach has basically been adopted by the theory of economic policy from Tinbergen onwards. Even in the cases when it is based on some welfare function or on the idea of the benevolent dictator or of the optimal planner, the goals or targets are taken as given in one way or another. The policy aspect in that is to find the best instrument or instruments according to some, usually pre-specified, criteria of policy choice. In a way, in the international setting, that is how the multilateral organizations like the United Nations or the World Trade Organization function.

Keynesian approach differs in that it allows for some deliberation over the choice of goals or targets and for an interaction on that between the decision maker and the advisors or supporters (probably best exemplified in his essays collected in his “Essays in Persuasion”). The idea is that the policy maker can be persuaded, by argument or some other incentive, about the aims that are worth achieving. This is in a way embedded in the idea of ownership that plays a prominent role in most programs that can be implemented with the active participation of the policy makers. This is certainly true of many international programs irrespective of the instruments that they rely on: e.g. irrespective of whether they use aid, grants, transfers, loans or investments. It is clear that the choice of the instruments does not determine the choice of the targets (instruments underdetermine targets), so the policy makers need to be persuaded that they should embrace certain goals or targets with some assistance when it comes to the means or instruments that they can rely on to achieve them. The very process of persuasion (“the art of persuasion”) is not easy to structure and there are quite a number of mostly loose ideas on how to ensure that the policy makers take ownership of various programs that are available or they can choose from. It is not the case that if instruments are made available, desired targets will be chosen by the policy makers. Therefore, Keynesian approach seems to rely on the following reasoning:
Keynesian policy (persuasive): Given the instruments, chose the superior targets (which are not only in the interest of the policy makers but perhaps in the public interest too).

The third approach is that of public choice theory. The gist of it is contained in the idea about the time inconsistency of policies and in the advice to prefer rules over discretion (Buchanan, 1975, Kydland and Prescott, 1977). Perhaps the easiest way to summarize it is to outline a two stage procedure of decision making. At one stage the rules are chosen while at another the policies are designed conditional on the rules that have been adopted. For instance, at one stage the choice is made to join the EU, while at another the policies are designed which are consistent with the ultimate end of EU integration, but are also consistent with the aims or targets that are consistent with the interests of the policy makers. Clearly, the immediate policies chosen need to be sustainable in the sense that they should support the policies aimed at the achievement of the final goal, but should also be compatible with the short term and medium term interests of the policy makers. One way to rationalize this approach is to say that the final goal is in the common interest while the policy targets are in the interest of the feasible political coalitions. In other words, there is a Pareto-improving policy in the long run and various distributional policies, policies with winners and losers, in the short and medium run.

Public choice policy (rules constrained policies): Given the long run ends, choose either (i) instrument given the targets a la Weber or (ii) superior targets given the instruments a la Keynes.

The EU relationship with the FMS is basically such as to require the public choice type of an approach. The FMS are to choose long term institutional set up by engaging with the EU. The question is whether there are short term and medium term targets and instruments that the EU can rely on in its relationship with the FMS and which indicators would be useful if there were such policies available?

Maintaining stability: IMF model for financial programming

The main model of multilateral influence on short term policy design in the Keynesian manner is that of the IMF. Its aim is to support, by advice and financially, the policy of stabilization of external balances of member states of the IMF. It has been noticed repeatedly that the model that the IMF uses for financial programming with its member states has not changed significantly since it was put together in the late 1950s. The main author, J. J. Polak (thus the Polak Model of monetary approach to balance of payments) discussed it in 1957, 1997 and in 2001 and presented its simple version a number of times (e.g. in Polak 1997). It consists of four equations:
\[ L = kY \text{ or } \Delta L = k\Delta Y \quad \text{(demand for money)} \]  
\[ M = mY \quad \text{(import propensity of income)} \]  
\[ \Delta L = \Delta R + \Delta D \quad \text{(money supply)} \]  
\[ \Delta R = X - M + K \quad \text{(balance of payments)} \]

where \( L \) stands for liquidity or money, \( k \) is the inverse of the velocity of circulation, \( Y \) is national income (or GDP or GNP), \( M \) is imports, \( m \) is the marginal propensity to import, \( X \) is exports, \( K \) is net capital inflow to the nonbanking sector, \( R \) is reserves, and \( D \) domestic credit of the banking system. All variables are in nominal terms and are therefore written in capital letters (lower case letters are for variables in real terms); the parameters, \( k \) and \( m \), of course, have to be estimated or their values have to be calibrated. Once estimated or calibrated, they are assumed to be stable or not to change very much in the short run.

Equation (1) is the quantity of money equation (if \( k \) is substituted by \( 1/v \), \( v \) being velocity, that becomes clear); (2) links imports to income with some perhaps stable propensity to import; (3) is the change in the money stock due to increased reserves or the expansion of domestic credit; (4) is the balance of payments expressed as a change in the reserves. Equation (3) can be replaced by two other equations:

\[ \Delta H = \Delta R + \Delta DCB \quad \text{(5)} \]
\[ \Delta L = q\Delta H \quad \text{(6)} \]

where \( H \) is reserve money (currency and reserves of commercial banks), \( DCB \) is central bank credit and \( q \) is the money multiplier.

Polak (2001) combines equations (1) to (4) into one as follows:

\[ \Delta Y = \frac{1}{k}(\Delta D + X + K - mY) \quad \text{(7)} \]

with \( \Delta Y \), \( L \) and \( M \) being determined by the exogenous variables \( \Delta D \), \( X \) and \( K \). If equation (3) is replaced by equations (5) and (6), equation (7) is replaced by the following

\[ \Delta Y = \frac{q}{k} (X + K - mY + \Delta DCB) \quad \text{(8)} \]

The assumption is that income, the stock of money, and imports are endogenous, while exports and capital inflows are determined by external demand and policy makers can only influence the growth of credit. Monetary policy in terms of interest rate setting in the money market is not considered to be feasible – probably because it is assumed that membership in the IMF precludes competitive devaluations and implies a certain level of liberalization of foreign trade. This also justifies the assumption that imports are exogenous and that, in turn, does suggest that capital inflows to the non-banking system are exogenous too.

Given that interest rates are determined endogenously, due to international mobility of capital, the policy instrument that is available is the control over domestic credit growth. That can be
done primarily via the control of the reserves of the banking system and of the central bank in particular, which is what equation (8) says. If money multiplier, velocity of money, and import propensity do not change or are reasonably stable, the increase of domestic credit will lead to an equal increase of imports, over time. Similarly, one time increase of exports will lead only to a temporary improvement in the balance of payments. Perhaps the main implication of the model is the following:

\[ \Delta D = - \Delta R \]  

(9)

In other words, change in domestic credit leads to the same, but opposite, change in the reserves (over time, though, via the income-expenditure multiplier process). This relation also suggests the main policy target and instrument nexus:
Instrument: \( \Delta D \) is the main policy instrument, and
Target: \( \Delta R \) is the main policy target.

In other words:

\[ \Delta R = f(\Delta D) \]  

(10)

Given this model, the policy variable is the control of the growth of domestic credit or, more specifically, as in equation (8), credit of the central bank (for instance, as is often the case, by a prohibition to lend to the fiscal authorities). The target is a certain level of reserves, which has to be chosen by the policy makers. So, management of reserves is the key policy issue, which also connects with the financing role that the IMF can play in supporting the chosen policy stance of monetary and the economic authorities in general. This has an implication for exchange rate policy irrespective of whether it is based on a fixed or a floating exchange rate. A certain idea of stability of the exchange rate is implied in the model, however. A pure float would lead to reserves, i.e. the target variable, being irrelevant, in which case this model would be irrelevant too. Similarly, it is hard to apply this model to monetary unions because of the divorce between monetary and fiscal policy, which divorces the instrument variable from the target variable, and the model becomes inapplicable. In the end, it is probably best suited for a small open economy with some policy options.

**Targeting growth: World Bank RMSM-X model**

The IMF model is essentially geared towards the short run and aims primarily at nominal stability. It cannot be reasonably expected to target growth. J. J. Polak (1997) has been of the opinion that it is hard to marry this model with medium term concerns, i.e., with concerns with growth of capacity (as opposed to the recovery of idle capacity). This has been the concern of
the World Bank model, the so-called RMSM-X model, which should support policies of development of the member states of the World Bank.

The RMSM-X model can be presented as follows:

\[
I = \Delta y/\sigma \quad \quad \quad \text{(investment)} \quad \quad \quad (11)
\]

\[
M = my \quad \quad \quad \quad \quad \quad \text{(imports)} \quad \quad \quad (12)
\]

\[
C_p = (1 - s)(y - T) \quad \quad \quad \text{(private consumption)} \quad \quad \quad (13)
\]

\[
\Delta R = X - M + \Delta K \quad \quad \quad \text{(balance of payments)} \quad \quad \quad (14)
\]

\[
y_{-1} + \Delta y = C_p + G + I + (X - M) \quad \text{(national income)} \quad \quad \quad (15)
\]

where \( I \) stands for investment, \( y \) is real GDP, \( 1/\sigma \) is incremental capital output ratio, \( C_p \) is private consumption, \( s \) is propensity to save, \( T \) is taxes, and \( G \) is government consumption. Target variables are \( \Delta R \) and \( \Delta y \), policy instruments are \( G \), \( T \), \( \Delta K \), endogenous variables are \( I \), \( C_p \), \( M \), and exogenous variable is \( X \). Target equations are:

\[
\Delta y = (s + m)Y_{-1} + (1 - s)T - (X + G)/1/\sigma - (s + m) \quad (16)
\]

\[
\Delta R = X - m(Y_{-1} + \Delta y) + \Delta K \quad (17)
\]

The main exercise is to determine foreign investment needs given the trade gap \( X - M \) and \( \Delta K \) and the solution to \( \Delta y/\sigma \) in equation (10) given the reserve and growth rate targets. The investment gap, given the targeted growth rate, suggests the level of World Bank lending. To simplify, the main policy design is to increase investments in order to target a sustainable growth rate, given stable external balances; i.e.:

\[
\Delta y = g(\Delta I) \text{ conditional on } \Delta R = f(\Delta D) \quad (18)
\]

Also, it is easy to determine both private and public spending for the determined growth rate or reserve requirement.

\[
C_p = y_{-1} + \Delta y - \Delta y/\sigma - X - m(y_{-1} + \Delta y) - G \quad (19)
\]

\[
G = y_{-1} + \Delta y - \Delta y/\sigma - X - m(y_{-1} + \Delta y) - C_p \quad (20)
\]

There have been various attempts to integrate the two models – to construct a model for stability and growth (Reinhardt,1990, Agenor, 2000). Theoretically, that is not very difficult, because both models work with simple macroeconomic balance sheets. Their merger, however, does not change practically anything in the operational side of the IMF model, while it does condition growth on a particular conception of macroeconomic stability.

Both the IMF and the World Bank models are simple enough that they can coexist with each other and with various extensions, modelled or ad hoc ones. Indeed, surveys of actual IMF programs have found that the implementation has been rather flexible, beyond the core concern with credit development (Edwards, 1990), and similar conclusions follow from the inspection of the World Bank programs (Easterly, 2004). It is probably true that most of the fiscal and
structural criteria are added in an *ad hoc* and eclectic manner and do not necessarily serve
either the aim of ensuring stability or promoting growth. This is true of the Washington
Consensus, for instance, and may prove to be true of the new approach to stability and growth
that is now being developed too. This will be discussed presently, but it is important to clarify
that the models of the IFIs are not structural and therefore mostly because the institutional and
structural reforms are not easy to introduce in this limited framework of policy support that these
multilateral institutions are tasked to offer.
In summary: the IMF model aims to determine the reserve gap (and the need for IMF loans) to
maintain stability in the short run, while the World Bank model aims to determine the investment
gap (and the need for World Bank credit) to target growth in the medium run. This is very much
in accordance with their respective briefs: they lend money for short term stabilization of the
external balance and for medium term growth sustainability.

**Fiscal policy, exchange rates and structural reforms**

Fiscal criteria figure prominently in most stand-by agreements, but the fiscal deficit target does
not play a role, at least not explicitly, in the basic IMF model for financial programming. A cap on
fiscal deficit can be easily added to the model if it is assumed that fiscal deficit is financed from
domestic or foreign borrowing:

\[
G - T = \Delta D + \Delta K
\]  
(21)

In both cases, an increase in fiscal deficit leads to the deterioration of the balance of payments if
it leads, as it will in this model, to more imports. If, however, domestic credit expansion has a
ceiling, as it will have if a certain level of reserves is targeted, increased public borrowing will
limit the availability of credit to the private sector (there will be a crowding-out effect). Thus,
either for political economy reasons, i.e. fiscal dominance over monetary policy, or for reasons
of credit rationing and in order to limit the crowding out of private debtors, fiscal deficit ceiling
usually enters as a condition for IMF programs.
Similarly, exchange rate adjustment may be part of a stand-by agreement. It can be introduced
in the following way, e.g.:

\[
\Delta Y = \Delta y + \Delta P
\]  
(21)
\[
\Delta P = \Delta P_d + \Delta E
\]  
(22)

where \( P \) is inflation, \( P_d \) is domestic part of inflation, and \( E \) is the exchange rate. The mechanism
is still the same. Growth of nominal income has consequences for the external balances and
thus for the change in reserves. To the extent that exchange rate change contributes to inflation,
it will contribute to the change in reserves. Because of that, it is easier to assume that the
exchange rate is stable, or indeed, because that assumption will deliver a simple way to determine the target variable, the level of reserves, and to quantify the control over the instrument variable, the change in domestic, or central bank, credit. In addition, stable exchange rate will provide an anchor for inflation, which is why it is often used as an intermediate target of monetary policy (Reinhardt, 2000, Obstfeld and Rogoff, 2001, Calvo and Reinhardt, 2002).

Of course, domestic prices can increase faster than the overall prices, in which case the exchange rate will be appreciating in real terms, while it will be depreciating if overall prices are increasing faster than the domestic prices. In other words, if prices of tradeables are increasing relative to prices of nontradeables, real exchange rate will be depreciating (more nontradeables will have to be given up in order to buy a certain amount of tradeables; i.e. imports will cost more in terms of e.g. labour services). In that sense, inflation and exchange rate volatility may be treated as indicators of vulnerability of external balances in the context of IMF monetary model and can be seen as putting a drag on the World Bank model of growth. However, considerations about real exchange rates do not enter the IMF and the World Bank models in an operational way.

The monetary model outlined above should work with fixed exchange rates because it can achieve an improvement in the balance of payments by slowing down imports through more restricted credit expansion. If imports are a constant share of income that will mean that adjustment will have to take place via negative growth of income. Alternatively, if the exchange rate is judged to be in fundamental imbalance, devaluation is appropriate. It is not clear how fundamental imbalance is determined, however, but many IMF stand-by programs have included nominal devaluations. In principle, the IMF model does not have to be committed to fixed exchange rates, though it will imply certain nominal exchange rate stability as it targets the level of reserves, usually by setting a floor to it. But that can be achieved with managed flexibility as well as with a strictly fixed exchange rate.

In the implementation of the various IMF and World Bank programs, structural criteria have increasingly played a role, at least until recently (Krueger, 1998, Goldstein, 2000). This was not only for reasons of stability, but also because of the increasing concerns with growth performance. A model that combines short-term stability with long-term growth is available and represents a merger between the IMF and the World Bank macroeconomic models (Agenor, 2000). In a nutshell, the nominal and the real side are decomposed and the real side is treated to some standard growth model. The merged model then targets growth of reserves, price stability and real growth of GDP. These targets have been found to be difficult to reach by policy instruments alone, because of too many influences that remain outside of the models, so that
structural reforms are often suggested in order to set up the necessary institutions and autonomous mechanisms that make it possible to utilize nominal stability to promote growth. The logic of the structural reforms within the policy modelling could be perhaps exposited as follows.

Once a simple policy model for stability, like the IMF monetary model of balance of payments, is combined with a model for policies for development, for instance, the World Bank model of growth, the complexity increases, which, as Polak (2001) has argued, leads to the fast growth of the number of parameters that need to be either estimated or determined by various assumptions. Estimating that many parameters is usually very difficult to do with the available data or with any data, so that a lot needs to be assumed. These assumptions take the form of structural relations and indicators, which then lead to the suggestions for structural policy measures or reforms of structural characteristics. In other words, the structural character of the models is buttressed by the assumptions on how structural polices influence the stability of certain relations and parameters and thus make it easier to choose targets and instruments of short terms policies or those that target medium term growth. That basically means that certain types of regulations should be introduced and implemented in order to make sure, for instance, that markets function efficiently and that, also, policies chosen support stability and growth and perhaps, in addition, certain other e.g. distributional goals.

There is, however, no agreement about how to do that (Lucas, 1975). Also, it is not clear whether conditioning some stabilization program on structural performance criteria is really helpful (Easterly, 2004). Certainly, much of what went by as the Washington Consensus, i.e. the consensus of the Washington based International Financial Institutions (IFI, i.e. the IMF and the World Bank) is not considered adequate any more or at least there is certainly no consensus any more about the model of structural reforms that is an adequate support of stability and growth, in Washington or anywhere else for that matter. Table 1 (taken over from Rodrik, 2006) lists ten economic and structural policies of the original Washington Consensus and adds the list of other ten policies that have been proposed by the IFIs or by other institutions or researchers. They boil down to fiscal and monetary rules, trade and investments policies of liberalization, and to suggestions on institutional development and good governance. The latter especially in the proposals for the extensions of the original consensus, which were seen as needed due to the experience with the crises and transitions that took place in the 1990s in Asia and in Eastern Europe. The main controversy, as is well known, has been about the way to open up the capital account and about the contribution that the quality of institutions and of
governance have on economic growth and development (Kose, Prasad, Rogoff, and Wei, 2006).

Table 1

The Augmented Washington Consensus

<table>
<thead>
<tr>
<th>Original Washington Consensus</th>
<th>“Augmented” Washington Consensus</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>the previous 10 items, plus:</td>
</tr>
<tr>
<td>1. Fiscal discipline</td>
<td>11. Corporate governance</td>
</tr>
<tr>
<td>2. Reorientation of public expenditures</td>
<td>12. Anti-corruption</td>
</tr>
<tr>
<td>3. Tax reform</td>
<td>13. Flexible labor markets</td>
</tr>
<tr>
<td>5. Unified and competitive exchange rates</td>
<td>15. Financial codes and standards</td>
</tr>
<tr>
<td>7. Openness to DFI</td>
<td>17. Non-intermediate exchange rate regimes</td>
</tr>
<tr>
<td>10. Secure Property Rights</td>
<td>20. Targeted poverty reduction</td>
</tr>
</tbody>
</table>

These structural policies are neither required by nor are they in conflict with the policy models for stability and growth. The real question is whether they are supportive of short term stability programs and medium term growth policies. That is not really clear. This is for theoretical and empirical reasons.

From a theoretical point of view, much of the discussion on the evaluation of policies has been influenced by the Lucas Critique. The point of it is that if policy regimes change erratically, e.g. in a discretionary manner, various economic agents, be it households or businesses, cannot follow a clear maximizing strategy and cannot be assumed to form rational expectations. In addition, if time consistency of discretionary policies cannot be expected, policy makers will tend to distort economic behaviour constantly. The solution is for policies to follow rules, which is what these structural characteristics are all about. Clearly, structural reforms require changes in
rules, but those should be supportive of stability and growth after the reforms have been introduced.

Empirically, however, there is no clear support for almost any of these rules and structural reforms. Indeed, in almost twenty years after the Washington Consensus was announced, no consensus was established, largely because there were series of crises the outbreak of which were attributed to one or the other of the structural reforms from the original or the augmented Washington Consensus tool-kit. At one point, an attempt was made to argue that the facts support the conclusion that wholesale, rather than piecemeal, implementation of the Washington Consensus is good for stability and growth. This, however, has also been challenged by the current financial crisis in the developed world that has institutions and policies that reasonably approximate those listed in the Washington Consensus and other similar comprehensive proposals for institutional and policy building and reform.

Thus, it is difficult to integrate structural indicators and structural reforms within a model of adjustment and growth. It is not difficult, however, to add them in an *ad hoc* manner.

**The new IMF approach**

The IMF model has been developed on the assumption that developing economies will experience secular growth with external imbalances that will be the consequence of too rapid credit expansion in the context of stable (fixed) exchange rates (Polak, 1997). Thus, credit slowdown to correct for imbalances has been seen as the major policy instrument. Things look different if global economy is declining, which is what is happening now. Currently, declining availability of credit is the main problem rather than its too rapid expansion. In these circumstances, the IMF has been tasked to increase lending in order to expand the availability of credit rather than to worry about setting a ceiling to its expansion. The existing IMF model, however, is probably not adequate in the case of decline in global demand or at least in the cases in which recession is taking place in countries with significant external imbalances. The latter are mostly the countries in Eastern Europe, among them quite prominently those that are future member states of the European Union (though most new member states, NMS, from Central Europe and the Baltic are in a similar condition).

In some cases in the last few decades, the application of the usual IMF model has proved to be inadequate when the recovery was more successful than it was expected. In those cases, credit ceilings proved to be inadequate because they turned out to be too restrictive. This is because sharp devaluations have led to fast and enduring corrections in the trade balance (through the expansion of exports) and thus to much faster accumulation of reserves, which supported much
faster relaxation of credit limitations and of the monetary policy in general. In some other cases, demand for money equation has proved to be too unstable for the model to be useful. In the third type of countries, inflation was more of a problem, and the standard IMF model does not deal with that problem directly. Also, lack of concern for growth has proved to limit the usefulness of the IMF programs for stability in converging and emerging economies. On the other hand, the combined model for stability and growth is dependant on too many parameters to be useful for policy purposes (see Blanchard 2008 on extensive macro models).

The problems that are being faced at the moment are different. The candidate and potential candidate countries (that is future member states, FMS) are experiencing sharp decline in the inflow of foreign finances and need to substitute them with the expansion of domestic credit. However, they also run high current account deficits and have been facing significant external imbalances prior to the eruption of the current global financial and economic crisis. As a consequence, they are facing a policy dilemma, at least from the point of view of the standard IMF financial programming model.

On one hand, external imbalances are suggesting that some tightening of domestic credit would be desirable in order to maintain the necessary level of reserves, which may be depleting also because of the decline in foreign currency inflows or even net outflows. On the other hand, recession and disinflation suggest that credit should be made available in order to support activity. In this context, the IMF has approached the issues in various countries in a pragmatic and *ad hoc* manner. That has led to different approaches in different countries, though the circumstances do not necessarily warrant that.

In any case, for the moment, it can be argued that the IMF new approach is not based on a new model and in some cases the old model has proved to be part of the problem rather than part of the solution. In some cases, IMF has continued to suggest fiscal and monetary restraint even though the exogenous influences have been recessionary (this practice seems to be continuously relaxed, though not in a systematic manner). Irrespective of how the causal arrow is turned, exports are declining in FMS and capital inflows also. In the case of countries with access to credit, domestic of foreign, IMF supports the governments to increase public spending and domestic credit irrespective of their balance of payments position. In the case of countries that have difficulties with raising money in foreign financial markets, the IMF is ready to lend money in order to support their reserve position, but is reluctant or cautious to go along with fiscal stimuli and with the suggestions for the expansion of domestic credit.

In the new IMF approach there are various changes that are not necessarily essential. Some aim to improve IMF’s reputation and make it easier for member states to seek its financial
assistance. Some change the so-called prior action criteria and also relax the conditionality of the structural adjustment criteria. As these do not constitute the core of the IMF programs anyway, these changes are important, but not really essential. Still, it is important to note that the IMF is basically discontinuing the conditioning of the access to their funds on structural indicators (except where it proves to be really necessary; it is not clear what is the decision criterion on that).

One change that can prove to be consequential is the introduction of sustainability as a criterion for external and fiscal imbalances. Another is the creation of fast track financial credit line that can be used by countries with good macroeconomic and financial record.

Sustainability as criterion of policy assessment is important, but it has yet to be properly defined. For instance, current account sustainability is hard to define if exchange rates are flexible. In that regime, it is not at all clear whether the IMF model makes sense because target variable is not easy to define: in principle, reserves should not be important in a country with a flexible exchange rate policy. If, however, fixed exchange rate is used to stabilize inflationary expectations, that policy may not be important in a deflationary environment, which is what is characteristic of the current economic developments.

Sustainability of the fiscal balances is somewhat easier to define. However, fiscal balances in a recession will almost always appear to be unsustainable because fiscal deficit will be high, interest rates will also be high, and growth rate will be negative. If these values are projected into the future, public debt to GDP ratio will grow without limit. So, some measure of potential growth is needed, but that may prove difficult to calculate for countries with relatively short record of stable growth.

In the case of FMS, fiscal balances have looked quite comfortable before the current economic crisis. They are bound to deteriorate with the decline of growth and the increase of fiscal deficits. These deficits will have to be financed from domestic sources as well as from abroad and will contribute to the maintenance of the current account imbalances with the possible deterioration of the reserve positions. In those circumstances, the IMF has suggested fiscal restraint in accordance with its operational model. This, however, looks as a wrong advice both from the pint of view of stability and of sustainability.

The reason is the following: if external demand is declining and inflow of foreign capital is also lower, domestic credit expansion, exchange rate depreciation, and high fiscal deficits are all sustainable because the main target variable is growth rather than stability. IMF has essentially adopted that approach to developed countries and the emerging markets, but not consistently for transition countries with relatively high external imbalances as are those in the Balkans, i.e.
the future member states of the European Union. Traditional IMF model if applied to these countries will deepen their recession, which may prove destabilizing and may lead to unsustainable external and internal balances. That policy stance may also prove detrimental to medium term recovery and long term growth prospects. This is because private and public debt positions will deteriorate and may prove to be a drag on the recovery and growth.

The EU and the IMF

There was an assumption that the IMF will be out of the FMS region permanently and that the EU should take over some responsibilities for stability and growth of these future member states of the EU. This assumption proved wrong in the current crisis. Indeed, the EU saw the need to call back the IMF not only in the case of FMS, but also in the case of NMS. Some of the countries in both groups proved to have problems with maintaining macroeconomic stability and needed an outside support. The EU seemed not to have the knowledge, the credibility and the instruments to do it on its own. As a consequence, some of the financial support programs within the EU have been led by the IMF and this is even truer for the FMS, where the IMF is practically the key outside stabilizer.

The problem that the EU faces is, as already mentioned, one of expertise, the credibility and the lack of policy instruments. These will be shortly discussed in turn.

Though there are doubts about the validity of the IMF model in any of its variants, the EU lacks any model whatsoever. This is for a good reason. The IMF model is adapted to its mission. It is to promote stability (and growth, but that is secondary) with a lending facility. The EU is supposed to provide stability and growth, but mostly in an indirect way. In the case of the euro area, there are monetary policy instruments, but there is no common fiscal agent and banking supervision is federalized. There are even fewer possibilities to support stability in the countries outside of the euro area. Though the EU can borrow money on behalf of its member states that are outside of the euro area, it is not obvious that it has a way to condition adequately the use of these loans (which is the reason that it relies increasingly on the IMF). In the absence of a clear role of the EU in supporting the macroeconomic stability of its member states, there is no easy way to put together a model of financial or growth programming. In normal circumstances, the Growth and Stability Pact could be relied on, but the Pact is practically irrelevant in the case of recession, especially a severe one.

Credibility is an issue because of the lack of fiscal support and of a clear connection between the financial support for macroeconomic stability and the financial stability in general, i.e. in the banking sector. One role that the IMF performs is that it lends money that is not supposed to be
used for fiscal purposes, but is ultimately supposed to be stabilizing the financial and thus the banking system. In the current crisis, the IMF has coordinated the refinancing of the loans of foreign banks operating in countries that face risks of financial destabilization. Though most of these banks are EU banks, the EU does not seem to have the needed credibility to stabilize their performance in FMS and even in NMS. As a consequence, the EU borrows the credibility from the IMF.

Finally, there is a lack of policy instruments. Again, the situation is different in the euro area than in the non-euro NMS and in FMS. IMF can influence the policy instrument, control of money supply, because it acts as a surrogate central bank for countries that have problems with financial stability. The EU, however, lacks that instrument and generally lack instruments for short term interventions. There is more scope for interventions that are geared towards supporting growth and medium term developments in general. But even those are mostly indirect and not necessarily easy to implement.

These deficiencies explain the need to rely on the IMF programs to coordinate the EU reaction to problems with stability and growth in the FMS. Still, given the high level of integration with the EU and the process of accession that is bound to end with the joining on the EU, there are ample reasons to think about the ways in which the EU could monitor the development of these economies and in time develop the knowledge, the credibility and the policy instruments to support their stability and growth. This is also justified by the expectation that the IMF may not be needed once the current crisis is over and stability and growth return to the FMS.

**Sustainability and risks: the EU approach**

The IFIs attempt to influence policies within a clear target and instrument framework. In addition, they rely on financial incentives to influence the design of policies – both in the choice of targets and in the implementation of instruments; that is the Keynesian approach to policy influence. Finally, their approach is structured in such a way that reforms are conditioned on growth which is conditioned on stability. Schematically:

*IFIs’ policy strategy: stability → growth → sustainability.*

The EU approach, however, is based on what has been called a public choice approach. It starts with the long term commitment, supported by a contract, which should support convergence growth through reforms, which in turn should ensure short term stability. Schematically:

*EU policy strategy: sustainability → growth → stability.*
The IFIs’ strategy is based on the assumption that a developing or an emerging economy will face challenging problems with its external balances and will be too risky to attract the needed investments. Thus, stabilization policy and investment support are both needed and should be provided by the IFIs. The EU strategy is based on the assumption that the expectation of institutional changes and structural adjustments will lead to a decline in risks, which will lead to sizeable and sustainable inflow of foreign investments. In addition, fast growth will lead to sustainable external balances, though external deficits may stay at a high level over an extended period of time.

One way to summarize the EU strategy is in simple terms of the uncovered interest rate parity equation. If the expectation of favourable developments are sustained, interest rates (e.g. long term interest rates) in the FMS should secularly decline approaching the levels in the, e.g., euro area. That should lead to higher growth rates via e.g. a Taylor type of rule: actual growth rate will be equal to the potential growth rate, which is higher in a less developed economy. As a consequence, uncovered interest rate parity equation would suggest an appreciation of the exchange rate: nominal if it is flexible and real if it is not. In other words:

\[ g_{\text{FMS}i} - g_{\text{EURO}i} = \Delta FMS_e \]  

(23)

where \( g \) is the growth rate, \( FMS_i \) is the interest rate in the FMS, \( EURO_i \) is interest rate in the euro area and \( FMS_e \) is the exchange rate of the FMS currency in euro. Therefore, short term considerations depend on the development of risks and on the sustainability of the growth rate given the sustainability of the external balances.

The EU policy approach can be represented schematically like in Table 2.
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<td>Long term</td>
<td>Integration</td>
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<td>Institutional and structural harmonization (Copenhagen criteria,</td>
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<td>Maastricht criteria); Negotiations and contracts (asymmetric liberalization)</td>
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<td>Medium term</td>
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<td>IPA funds</td>
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<td>Consultation on the basis of European Partnership; medium-term economic and</td>
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<td>fiscal programming</td>
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<td>Short term</td>
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<td>MFA (macro financial assistance)</td>
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<td>Policy dialogue</td>
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This framework is very much in tune with the policy set up within the EU itself. There is a strong common regulatory authority that is centred around and flows from the existence of the single market (customs union); there is currency union with an independent central bank with rule based monetary policy and the conditions to acceding to the currency union; there is a rule based coordination of fiscal policies called the Stability and Growth Pact; there are transfers for structural adjustment; there is the principle of subsidiarity in most other policy areas, e.g. in the area of financial supervision and in most other short term policy choices, both when it comes to the choice of targets and to the choice of instruments. Table 29 suggests that the same approach, or an approximation of it, is applied to the FMS, which implies that medium run goals and short term targets are either underdetermined by instruments in the case of the former or are not even clearly defined in the case of the latter.

It is clear from the table that the EU has not developed the framework for short term policy support both in terms of the procedure of communication and in terms of instruments of persuasion and support. It relied on the IMF for that and has turned to the IMF and the other IFIs for support in the current crisis. As a consequence, it is bound to rely on the IMF model and on the assessment of the IMF on the risks and vulnerabilities for macroeconomic as well as for
financial stability. This may not seat well with the strategy of policy engagement that the EU needs to follow given its long term ends.

**Long term criteria**

There is no need to go into details when it comes to the long term policy engagement of the EU with the FMS: those are well-known from the previous bouts of enlargement and thus there is ample experience. The end, the procedure, the phases and the instruments are quite clear and are contained in the process of accession, in the Copenhagen Criteria, in the Maastricht Criteria (when it comes to the adoption of euro), and in the succession of negotiations on contractual relations of the FMS with the EU. It may be useful to note that the whole process is based on the strategy of structural reforms supporting convergence growth and that in turn should sustain macroeconomic and microeconomic, e.g. financial stability.

The process starts with the free trade agreement, the Stabilization and Association Agreement (SAA), very much in the Weberian manner, but with a promise of eventual accession to full membership in the EU. It continues, in the context of the implementation of the SAA, with the financial support of the EU for structural adjustment (IPA funds), very much in the Keynesian spirit, and ends with the negotiation on the membership contract. This last step is of course anticipated from the very beginning, which gives a distinct public choice flavour to the overall policy approach to adjustment, transition and finally accession: there is an *ex ante* commitment to institutional and structural reform which supports changes in policy regimes (e.g. market liberalization), and influences short term policies.

There are three sets of long term criteria that should be used to monitor the progress and also the risks along the convergence path. The one is part of the pre-accession process and monitors the progress of the of candidate and potential candidate countries in satisfying the Copenhagen criteria. An extensive review of the progress is conducted each year; see e.g. “Progress towards meeting the economic criteria for accession: the assessments of the 2008 Progress Reports” (European Economy Occasional Papers 44, March 2009). Progress Reports are compiled each year and track each individual country’s compliance with the Copenhagen Criteria.

The two economic Copenhagen criteria are the existence of the functioning market economy and the ability to cope with the competitive pressures and market forces within the European Union. Both criteria are not easy to generalize.

The first – functioning market economy – most probably needs to be conceptualized so that prices are set by the markets, which suggests various criteria for flexibility of all the relevant
markets (e.g. product, labour, financial and other markets for services). In addition, the regulation of markets needs to be such as to target market failures and not some specific commercial, social or political goals or aims. These criteria are essentially given by the regulatory regimes in the EU and this part of the assessment of the progress of FMS is based on the degree of harmonization with the EU rules and regulations.

The second criterion – ability to cope with competitive pressures and market forces, the criterion of competitiveness for short – is somewhat more difficult to conceptualize. In some sense, every economy is capable of coping with competitive pressures in some way. The real question is whether it is coping in such way that it is converging with the other economies in the customs and later in the currency union. This is the question of the degree of specialization and of diversification. A small economy is expected to be more specialized in the product market, but it is also expected to be sufficiently diversified so that it is not susceptible to asymmetric shocks. In that sense, the criterion of competitiveness could be understood as assessing the degree of diversification during the period of accession to the EU and adjustment to the single market, because the instruments of intervention in the development of the competitiveness will be mostly lacking after the accession.

In this context then, indicators of diversity and specialization should be developed; and, by implication, the assessment of the policies in terms of supporting diversification and specialization in production, trade and in the labour markets. The overall balance is given by the fact that customs union precedes the currency union, but more specific indicators may be needed too. The key problem, however, is that the EU does not have the instruments to influence the development of competitiveness of FMS. It is left to them to choose, within the process of trade and financial liberalization, to target one or the other type of comparative advantages that they want to rely on. The introduction of the indicators of diversity and specialization may help suggest policies, but will probably not influence their choice.

In the same spirit, the development of the human capital is important. Connected with that, the developments in the labour markets, not only domestic but also international should be followed, because migration is an important fact of Balkan economies. The EU has indirect instruments to influence labour market developments and human capital acquisition and those should be identified and developed with the view of influencing the long term developments and the policy choice which are appropriate for those developments.

The other set of indicators incorporates the sustainability analysis set out in this study. Clearly, the sustainability of the external and internal balances could be monitored continuously. Thus:

Foreign debt sustainability as an indicator of current account sustainability
Public debt sustainability as an indicator of the sustainability of fiscal balances
Credit to GDP ratio as an indicator of financial sustainability
Private debt to GDP ratio as an indicator of financial sustainability of the households
These indicators depend mostly on the growth rate and the interest rate as has been pointed out in this study several times. To the extent that debt is in foreign currency, e.g. in euro, exchange rate development is important too. Given the nature of convergence growth, indicators of risk compression and of nominal and real exchange convergence are important, which is the third set of indicators that can be used here. Thus:
Long term interest rate spreads over those in euro as indicators of sustainable risk development
Nominal and real exchange rate appreciation as indicators of the sustainability of overall policy mix.
A number of other indicators have been put down in Part III of this study and are not reproduced here.

**Medium term criteria**

The crucial element of the whole strategy is the influence of the process of accession on the medium run development. The whole process of integration and accession lasts about ten years. That means that the medium term structural change is the key to the success of the whole process. In that, the process of growth take-off and of the sustainability of convergence growth is the key. The essential part of this process is the decline of risk to investments and the flow of investments and the structure that is emerging.

The key medium term target is the take off of growth and that of laying the grounds for its sustainability. The main instrument is support for investments. Unlike in the case of development finance, like the one advised and financed by the World Bank, the support is mainly for private investments. Some elements of development finance are the loans that are disbursed by the European Investment Bank, which are certainly important. Some were considered within the so-called Stability Pact for Southeast Europe, with little success though. However, the key to take-off of growth, its sustainability and of the convergence growth rate is considered to belong to private investments.

The way to influence growth of private investments is to lower the risks to investment. In the case of the World Bank model, investment gap is supposed to be filled up by loans from multilateral institutions, and perhaps sovereign creditors and donors, because the risks are too high to expect significant private inflow of investment into the developing economies. Over time, development assistance should lower these risks, and also overall costs through investments in
various public goods, and private investors could take over. In the case of the EU and the FMS, risks are supposed to go down quite quickly because of the positive effect of the expectation about the long term – that is of accession to the EU – which should be reinforced by the continuous process of integration with the EU, e.g. through trade and financial liberalization. Thus, risks to investments decline even before significant structural and institutional reforms have taken place. The EU does not support this process of risk reduction in any direct way and certainly not by significant financial means. Most of the influence goes via the assessment of the process of transition, within the context of the European Partnership, and via the speed of the process of accession. The development of risks is not all that well reflected by the ratings of sovereign and other bonds by international rating agencies, but can be more appropriately induced from the actual foreign investments. The latter have been quite significant and have suggested a quite speedy risk compression in the FMS. This has changed sharply now, due to the global financial crisis and the dramatic re-pricing of the risks of external and internal vulnerabilities. In that context, the EU can clearly play a role by providing support for the sustainability of the long term process through the stress it puts on medium term reforms.

The key instrument for the assessment of medium term economic and fiscal programmes of the FMS is the EU Commission assessment of “Pre-accession economic Programmes” (PEP) for candidate countries and of “Economic and fiscal programmes” (EFP) for potential candidate countries. The FMS are expected to submit mid term economic and fiscal programmes which are revised annually and assessed by the EU Commission. The most recent ones are from 2008 while the most recent assessments by the EU Commission are published as *European Economy Occasional Papers* 318 and 319 from June and July 2008 respectively. They discuss the programmes submitted by FMS by the end of 2007.

The content of the Programmes is centred on the overall policy mix, the medium term fiscal developments, and deals with planned structural reforms for the period of three years. The central part of the Programmes and the EU Assessment deals with the medium term fiscal plan and with its implementation. The key target is fiscal adjustment in order to support structural reforms and to achieve fiscal sustainability. Implicitly, the compliance with the Stability and Growth Pact is targeted because it will be regulative for these countries in the future.

As has been shown in this paper, fiscal sustainability is not a very strong constraint given high rate of convergent growth and even given the potential growth rate. This enables the FMS to aim at costly structural reforms and project sustainable fiscal developments at the same time. Indeed, in most countries public debt to GDP ratios continued to decline even if there were significant increases in public expenditures and fiscal policies have tended to be pro-cyclical.
Turkey presents an exception because of the strong fiscal adjustment that was necessary after the most recent exchange rate crisis. Thus, Turkey has been running significant primary surpluses in order to ensure the sustainability of its fiscal balances.

In standard IMF stabilization programmes, sustainability of fiscal and current accounts is tested. Various tests of potential shocks are performed in order to check whether either the foreign debt or the public debt tend to increase without limit, which indicates that they are unsustainable. These tests, along the lines that some of the exercises were done here, could be performed in order to test the sustainability of the macroeconomic policy mixes in one country or another. IMF stress tests usually check the effects of banking crisis in the form of the sharp rise of interest rates and of exchange rate crisis in the form of sharp devaluation. Similar test could be performed in order to check the effects of sharp increases in public debt to GDP ratios on interest rates and on the exchange rate. The latter exercises would be particularly important in the cases of recessions, as is indeed now the case. Current EU assessments do not rely on these stress tests.

Similarly, the test of the effects of sudden stop type of crisis could be performed, again along the lines suggested in this study. Clearly, the risk of default is not zero for countries with significant and enduring current account deficits. Indeed, as has been discussed in this study, elements of sudden stop type of crisis are to be detected in the current developments. Those may not arrive only as a complete cessation of foreign financing but also as secular decline or just stagnation of inflow of foreign resources. That will have, if it happens, an effect on the medium term growth, which in term will suggest a completely different prospect for foreign and public debt sustainability. That in turn will put pressure on structural reforms at the same time when fiscal reform is needed, which may be hard to implement politically.

All in all, assuming that structural reforms cost public money and assuming the need to ensure sustainability of public finances, these two targets are consistent only if growth rate is sufficiently high. Thus, the key criterion is the rate of growth, which means that policies need to be assessed from the point of view of their growth implications, which is what has been done in this paper.

The PEP and the EFP could be structured in such a way to assess the growth implications of economic and fiscal programmes and to check their sustainability with the tests suggested in this paper. Reforms would be checked for their growth implications while fiscal costs would be checked for their impact on the sustainability of the external and internal balances and of the key relative prices, i.e. interest rate and the exchange rate. Those assessments and test would suggest policy targets and instruments. Up to that point, the approach of the EU would be
entirely Weberian: the EU assessments would be in the form of an advice: if a country aims at these targets, it needs to use these instruments. In order to suggest targets, to move to Keynesian policy framework, some control over the instruments would be necessary. Given that growth is the key overall target, investment is the obvious instrument. The EU, however, cannot supply investments directly, which means that it needs to structure the medium term advice and support along the lines of suggestions for structural reforms that are compatible with the long term growth of integration.

It is certainly strange that there are few attempts to develop indicators of the development of risks and the lack of ideas about the policy instruments that could support the sustainability of this process of declining risks. This is especially true in the banking and financial sector in general. Again, the World Bank offers primarily sovereign loans because the banking and the financial sectors are taken not to be developed and stable enough. In the case of FMS, however, most of investments go via the banking sector, though there is little that the EU is ready to do to support the efficiency and stability of the financial sector in the FMS.

This lacuna is especially glaring because the high inflow of foreign financing will lead to sustained deficits in the current accounts and may cause an unsustainable development of the foreign debt. That, in turn, will put at risk the flow of investments and may trigger a sudden stop type of crisis with adverse consequences for growth and the process of convergence. It makes sense that the EU would want to take up more responsibility for monetary policy and for prudential oversight when it comes to the financial sector in the FMS.

The influence on the medium term developments is couched in the Weberian framework. There is no way to influence the choice of targets, except via the commitment to EU membership in the future, and the available instruments are used to achieve targets that the FMS choose more or less autonomously. The latter choice is constrained by the free trade and other arrangements that are part of the SAA, but this is of course an indirect influence. It is assumed that the authorities in FMS will draw the right policy implication from the long term end and from the opportunities that the medium term convergence growth offers. However, the FMS authorities may choose risky strategies rather than those that minimize risks and support investments.

Given that the development of risks is the key to medium term developments, those need to be defined and their development monitored. They can be classified according to their sources, e.g. according to markets that they may originate in or according to policies that may tend to address them, positively or adversely.

Financial market indicators (some of which have been looked at in Part I of this study)
Trade indicators (both of trade openness and of export and import specialization and diversification)

Labour market indicators (including the indicators of the flexibility of the labour markets, but also on structural characteristics of supply and demand)

Product market indicators (especially those that can be useful for competition policy)

Macroeconomic indicators (especially those that indicate structural reforms of the public sector and public finance)

The key criterion of evaluation of the development of these risks is that of sustainability: whether the underlying developments are sustainable or are not sustainable? Given that growth is the main target, the key issue is whether potential and expected growth support sustainable developments in the markets, given the policies that are being pursued. Some indicators to watch are those mentioned in Part IV of this study:

Domestic liability euroization: ratio of foreign currency loans to GDP

Size of the current account as a share of tradable goods absorption

Loan-to-deposit ratio of the banking sector

Foreign currency reserves as a ratio of broad money

Those indicators together with the appropriate stress and sustainability test could be usefully incorporated into the PEP and EFP instruments. Indirectly, those would have an influence on the risk assessment and that could ne an incentive, though not necessarily an incentive enough, to speed up the reforms and support more strongly growth and convergence.

**Short term targets and instruments**

In the wake of the current crisis, the EU has sought to strengthen its support for short term stability. There is already a fund for the support of macroeconomic financial stability (MFA), but it is quite small and its disbursement is premised on the existence of a financial arrangement with the IMF. Similarly, additional funds could be raised, but their disbursement depends on the existence of an IMF program. That just highlights the fact that the EU has no independent short term instruments that it might want to use to support the short term target of stability. Irrespective of that, it is expected that most of FMS will have an IMF programme at some time in the near future. The content of the programme is not hard to predict give the experience with the recent programmes in other countries in transition.

Stability is being tested in the current crisis. The need for a countercyclical policy response is almost as clear as it can possibly be. There is a need to address the main source of the short term risks, which is in the financial sector. Additionally, the sharp decline in private consumption
and investment requires an adequate response in the form of an increase in public consumption and investment. Finally, to the extent that current crisis will lead to permanent changes, relative prices need to be corrected.

None of these short term targets – stabilization of the financial sector, fiscal stimulus, and adjustment of relative prices – can be adequately addressed by the FMS individually, but the EU lacks instruments of support, perhaps even in the minimal sense of supplying a policy advice. These issues will be discussed in turn.

Clearly the most pressing short term risk is in the banking and financial sector in general. The balance sheet risks are mostly on the side of the assets. The banks need to deleverage because the risk of the growth of non-performing loans is increasing in most FMS. In addition, there is a growing risk of banks in FMS facing serious problems via their mother banks in the EU (Arvai, Driessen, Otker-Robe, 2008, Maechler and Ong, 2009). Both sources of risks cannot be directly addressed by the EU. Addressing them via the IMF, which is what is being done, may prove not to be adequate because the approach taken by the IMF, with all the revisionism that is taking hold in the institution, is still pro-cyclical, though in a milder form. With that in mind, an instrument needs to be found to address the problems in the banking sector directly.

One such instrument is the so-called Vienna Initiative, which needs to be followed rather closely. What it means is that foreign commercial banks present in a country sign a commitment on the invitation of the IMF to maintaining their presence in that particular country. Usually, that commitment follows the IMF standby programme with a country, but Bosnia and Herzegovina is an exception. That commitment is premised on IMF disbursing money to shore up central bank's reserves, which in turn is conditional on the country committing to fiscally prudent policies. In that way, IMF provides resources that banks can count on and supports the stability of the exchange rate. However, the assumption on the austerity of the fiscal policy is rather hard for these countries to commit to credibly. If there is a slippage in the implementation of the programme, the Vienna commitment can fall apart and stability may not be maintained. This, however, is at least in part the consequence of the precarious position of the financial balance sheets in the FMS. Though the data is lacking, there is no doubt that non-performing loans are increasing and the banks are looking at significant losses in most of these countries. Stability may be additionally threatened if the decline in fiscal spending leads to the deepening of the recession and to prolonged stagnation due to the extended process of deleveraging.

The appropriate indicators to follow here are those that are used when stress tests of the banks are performed. The EU is uniquely positioned to design stress tests for the banks that are stationed in the EU and operate in the FMS.
When it comes to the fiscal stimulus, one is clearly needed because the recession may prove to be quite deep and the recovery may prove to be quite sluggish. The main worry is that the FMS, even if they could borrow money, would boost imports, which would aggravate their main vulnerability, which is the external imbalance. Their deficits are mainly in the trade with the EU (deficits with Russia and the other energy exporting countries can be taken as given). This is of course in part the consequence of trade liberalization that is the initial step to EU integration. Because of that, the EU is again uniquely positioned to support fiscal expansion in the FMS. That would have to be coordinated with the fiscal expansion in the EU itself, which is an issue in itself.

The appropriate indicators to follow are those that detail the developments of public revenues, that are declining sharply, and public expenditures, that are also declining. Though some support has been provided for capital investments (in infrastructure, via the World Bank and the EIB), for medium and small size enterprises (via the EBRD), and for public consumption (via the IPA and, potentially, MFA), public expenditures are contracting and are adding to the recession and to the risks in the product and labour markets (for recent developments in the fiscal sector, see Figure 1; figures are nominal, so real adjustment is much stronger). Thus, the indicators about the latter would be important too.
In the short term, these fiscal developments do influence and are influenced by the development of the relative prices. The relative prices are important primarily because they will have an influence on the depth of the recession and on the exit strategy. The main issue is whether the crisis will lead to permanent structural changes, e.g. in the form of growth of the tradable sector. If it is not to be expected that capital inflows will be as generous as before and if private savings increase, because of the process of deleveraging of the banks, but also because of the increase in risks, the performance of exports becomes so much more important. That means that the real exchange rates need to adjust, i.e. they have to depreciate. In some cases, income policy could be relied on, but that may prove inefficient in a number of cases. That suggests nominal exchange rate adjustment. In the current circumstances, it may prove to be compatible with the reduction of the real interest rate, because inflation is not much of a worry.
The indicators to follow are those about the exchange rate, the interest rate, the indicators of various incomes, and other usual short term indicators. E.g. the usual Taylor Rule could be used to assess the gap between the actual and the interest rate implied by the Rule. Similarly, the augmented Taylor Rule could be used to assess the development of the exchange rate. Finally, the development of wages could be checked against that of productivity.

Some of the standard indicators have been looked at and commented on briefly in part I of this study. They are widely used. There is a need to be flexible about their choice and weight in the overall judgment that is being made on the basis of them all taken together. Also, they should be supplemented by the short term indicators used by the IMF which were discussed in this section of the study. Their policy relevance is in that they can indicate the necessary policy changes to stabilize the short term developments but even more to suggest structural changes that could get them in line with medium run and long run sustainability. The issue of proper structural reforms and of the sequencing of their introduction merits separate treatment. The issue is clearly important from the point of view of the EU approach to adjustment and integration.
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