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Trade and fiscal imbalances in Southeastern Europe: Can fiscal devaluation help?

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ABSTRACT

We examine the need, potential and likely effects of fiscal devaluation for a group of seven economies in Southeastern Europe. All the countries face external trade imbalances and most of them also experience large or growing fiscal problems. We conclude that fiscal devaluation could be a useful instrument to help these countries improve their trade balances without (further) deteriorating their fiscal positions. The results of our simulations show that a budget neutral fiscal devaluation in the amount of 1 percent of gross value added could yield short-run improvements in trade balances ranging from 0.56 to 0.94 percentage points of (initial) gross value added. Simultaneously, this is expected to have a positive impact on output as well, which should grow at rates between 0.15 and 0.25 percent.

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1. Introduction

The economies of Southeastern Europe[1] (SEE), despite being a heterogeneous group in many aspects, have been experiencing significant macroeconomic imbalances, especially in international trade. In addition, they are largely characterized by high unemployment rates and, in some countries, growing fiscal problems. Since the outbreak of the global financial crisis, economic growth in most of these countries has been rather weak. Given the low international competitiveness of the SEE economies (as reflected in large trade and current account deficits) and increasing economic growth constraints in the form of accumulated external and/or fiscal debt, it seems that the prospects of sustainable growth in the future will largely depend on the countries' ability to improve external competitiveness and increase net exports. Another important characteristic of the SEE economies is that they are heavily 'euroized' (Kosovo and Montenegro have even unilaterally adopted the euro as their official currency), so that currency devaluation is often considered as a non-viable option in achieving trade balance improvements.

An alternative instrument designed to mimic the effects of currency devaluation is a shift in the tax structure that can be implemented without affecting the fiscal balance. The basic form of such a fiscal devaluation (De Mooij and Keen, 2013) consists of increasing the value added tax (VAT) rate, while simultaneously reducing the rate of social security contributions

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[1] We analyze seven countries in the region: Albania, Bosnia and Herzegovina, Croatia, Kosovo, Macedonia, Montenegro and Serbia. In the EU nomenclature these countries are labeled as the Western Balkans.

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paid by employers (SSCR), in a budget neutral way (at least ex ante).[2] A higher VAT rate should reduce the imports of (consumption) goods, while lower SSCR rates should lead to lower production (labor) costs of domestic companies and hence facilitate import substitution and exports.

To our best knowledge, the present study is the first that tries to evaluate the effects of fiscal devaluation in SEE economies, yielding valuable results in designing fiscal policy for these countries in order to improve their external trade competitiveness. We first give an overview of the current macroeconomic situation and the developments since the beginning of the 2008 economic crisis in these countries. Special attention is devoted to external sector imbalances, as well as to fiscal developments. Afterwards, in the third section, we describe the idea of fiscal devaluation and give a brief overview of the current tax systems in the SEE economies. In the fourth section, we describe our modeling approach and perform simulations of the short-run effects of fiscal devaluation in these countries under three different scenarios and present the results. The last section concludes.

2. Macroeconomic developments

As shown in Table 1 below, all of the SEE economies have been able to achieve positive real GDP growth after the breakout of the economic crisis, *i.e.* between 2008 and 2013, except for Croatia, where real GDP declined by more than 12% over that period. However, substantial growth was recorded only in Albania, Kosovo[3] and (to a smaller extent) Macedonia, while in the other three countries, real GDP in 2013 was only slightly above the level of 2008. Kosovo and Macedonia were the only two countries to successfully lower unemployment during that period, but the unemployment rates in these two countries were still the highest in the region in 2013. In all other countries there has been an increase in unemployment, with the negative developments being most pronounced in Croatia and Serbia. At the same time, all countries experienced increases in real wages (which were particularly strong in Kosovo), except Croatia and Serbia, but in the latter case the real wage reduction has been of negligible size.

The second and third parts of the table show an overview of the developments in the external sectors of these economies. All the countries in the region recorded a negative current account balance in 2013 except for Croatia, where it was slightly positive (mainly on account of crisis related consumption and import restraints). The largest deficit of nearly 15% of GDP was recorded in Montenegro, despite a huge improvement of more than 35 p.p. in the current account balance since 2008. For all the observed countries the situation is even worse (or at least equally bad) if only the balance of trade in goods and services is considered: the recorded deficits range between −10.6% of GDP in Serbia and −31.6% in Kosovo. The deficits are even more pronounced if only trade in goods is considered (except for Albania) and range from −11.6% of GDP in Serbia to −40% in Montenegro.

One should note that especially Croatia and Montenegro manage to cover a large part of their trade in goods deficits through surplus in trade in services, mostly *via* tourism. Overall, the trade imbalances are still large despite considerable improvements over the period since the beginning of the crisis. In the majority of the countries in the region, improvements have been achieved at relatively stable real exchange rates. Only in Albania there has been a significant depreciation of the real exchange rate since 2008, which seems to have been driven mostly by the depreciation of the nominal exchange rate over the same period. In Serbia, on the other hand, the nominal exchange rate depreciated strongly, but without inducing competitiveness increases, as measured by the real exchange rate developments. Accumulated current account deficits led to significant increases in the external debt of these countries, amounting to over 9 p.p. of GDP in Bosnia and to more than 33 p.p. in Montenegro. As a result, in all countries in the region except for Kosovo, the ratios of external debt to GDP exceeded 60% in 2013, with the ratio for Croatia amounting to more than 105% of GDP. These developments are similarly reflected in the data on the net international investment position of the observed countries.

In addition to the external imbalances described above, the fiscal developments in these economies also display negative trends, as shown in the bottom part of Table 1. In 2013, all the countries were running general government budget deficits, ranging between −2% of GDP in Kosovo to −5.2% in Croatia. Although the deficits were cut everywhere except in Albania (in comparison to 2008), cumulatively they led to a significant deterioration in the ratio of general government debt and GDP during the period between 2008 and 2013 in the whole region except for Kosovo.

The problem was especially pronounced in Croatia and Serbia, where the ratio increased by 39.6 and 31.2 p.p., respectively. As a result, in 2013, Croatia and Albania had a public debt to GDP ratio in excess of 60%, while Montenegro and Serbia both got very close to this threshold. At the other extreme, Kosovo had a share of public debt in GDP of only 8.9%, therefore having a very strong fiscal position in this respect (this is also stressed in IMF, 2013b).

The international trade imbalances discussed above and the mostly negative fiscal trends (except in Kosovo) have been emphasized (among other issues) in the recent relevant documents by the IMF and the European Commission (EC). For example, the IMF (2013a) stresses the worsening of the trade and current account balances in Macedonia, as well as the quickly increasing public debt. The IMF (2013c) mentions the poor export performance in Montenegro (except for tourism),

[2] In this text, we abbreviate social security contributions in general as SSC, while SSCR stands for the part paid by employers and SSCE for the part paid by employees.

[3] IMF (2013b) finds that the economy of Kosovo has been resilient to the crisis due to limited financial and trade linkages and to robust remittances and FDI inflows from the diaspora.

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