Balkan Countries: the Path to Nominal (Economic) Convergence

[a]Merita (Boka) Toska, [b]Godiva Rembeci
[a]Polis University, International School of Architecture and Urban Development Policies & CoPlan-Institute for Habitat Development, Tirana, Albania
[b]Polis University, International School of Architecture and Urban Development Policies, Albania

---

Abstract

The European integration process presents a challenging objective for Balkan countries. The process has evolved gradually and the Balkan countries actually present a different status in the integration process. EU accession is subject to the Copenhagen criteria fulfillment: economic, political and *acquis communautaire*. Upon granting the *"member state"* status, the next step concerns participation in the Economic and Monetary Union (EMU) and introduction of the single currency. This stage is related to the Maastricht criteria fulfillment or nominal convergence criteria. The main objective of this paper is to assess the nominal convergence of the Balkan countries in terms of price stability, exchange rate stability, fiscal criteria and long term interest rate criteria. We will assess how macroeconomic indicators comply with Maastricht criteria requirements as by the end June 2015. Our main finding is that despite not meeting the Maastricht criteria as by the cutoff date, these countries are following the right path toward full effective European integration.
KEYWORDS: Balkan, EU, convergence criteria, inflation criteria, ERM II

INTRODUCTION

The European integration process represented a strategic objective for the Balkan countries since the beginning of the '90s. For the purposes of this study we will consider the following countries: Albania, Kosovo, Serbia, Macedonia and BiH. All of these countries share a common objective, the EU membership. EU membership is subject to the fulfillment of the Copenhagen criteria (ECC, 1993) as stated by the European Council in 1993: *"Membership requires that the candidate country has achieved stability of institutions guaranteeing democracy, rule of law, human rights and respect for and protection of minorities, the existence of a functioning market economy as well as the capacity to cope with competitive pressure and market forces within the Union. Membership presupposes the candidate's ability to take on the obligations of membership including adherence to the aims of political, economic and monetary union."* Once formally member of the European Union, Economic and Monetary Union and the single currency introduction would follow. This second stage is subject to the Maastricht criteria fulfillment (convergence criteria): price stability, exchange rate stability, fiscal criteria and long-term interest rate criteria. It should be noted, however, that a unilateral introduction of the common currency would not suffice: the euro can be introduced only in agreement with EU member countries and only after the EU accession. Such an agreement requires a two-year ERM II successful participation and the convergence criteria fulfillment.

Table 1. Current status of Balkan countries in the EU integration process

Candidate countries	Membership negotiations started	Potential candidate countries
Albania		Bosnia and Herzegovina
FYROM		Kosovo
Montenegro	November 2014	
Serbia	January 2014	

Source: http://ec.europa.eu/enlargement/countries/check-current-status/index_en.htm

Given the current dynamics and national aspirations, compliance of macroeconomic indicators with the Maastricht criteria gains significant research importance. Equally important is the matter of comparability: assessing whether these indicators are methodologically harmonized and thus comparable to those of the EU member states. Building on these two main aspects, this research paper will first assess the degree of Maastricht criteria fulfillment and progress conducted in achieving the preconditions for adoption of the euro. The study will be structured in three sections. After a short introduction, the second section will explore the Copenhagen and Maastricht criteria. In the third section we will assess compliance to nominal convergence criteria and degree of methodological harmonization. At the end conclusions and recommendation for future research.

FROM COPENHAGEN TO MAASTRICHT CRITERIA

In the European integration process there are two important sets of criteria to consider: (i) criteria that a potential new member state must fulfill in order to become a member country of the European Union – Copenhagen criteria fulfillment; and (ii) criteria that the member country must fulfill to obtain full membership in Economic and Monetary Union (EMU) and adopt the single common currency (euro) – Maastricht criteria fulfillment.

Copenhagen Criteria

After the fall of the Berlin Wall, Central and Eastern European countries showed their interest in joining the European Union. The European Council meeting in Copenhagen in June 1993 made an important decision in regard, concluding that the *"…the associated countries in Central and Eastern Europe that so desire shall become members of the European Union. Accession will take place as soon as an associated country is able to assume the obligations of membership by satisfying the economic and political conditions required"* (http://europa.eu/legislation_summaries/enlargement/ongoing_enlargement/l14536_en.htm). The Copenhagen criteria were augmented by the Madrid European Council (http://www.europarl.europa.eu/summits/mad1_en.htm) stating that a candidate country must create the conditions for its integration through the adjustments of its administrative structures. According to the Copenhagen criteria, qualification for membership includes:

- *Stability of institutions, guaranteeing democracy, the rule of law, human rights and the respect for and protection of minorities;*
- *Existence of a functioning market economy as well as the capacity to cope with competitive pressures and market forces within the Union;*

- *Ability to take on the obligations of membership (acquis), including adherence to the aims of political, economic and monetary union.*
- *The Union's capacity to absorb new members, while maintaining the momentum of European integration – principle EU self-imposed.*

The accession for a new member state is not automatic, it is a *step-by-step* process. Any wishing country, shall formally apply to the Council, which, subject to positive recommendation of the Commission and a favorable opinion by an absolute majority of the members of the European Parliament, makes its decision unanimously. Negotiations are not opened automatically, thus the aspirant member state should formally request it. For the Western Balkan countries, the roadmap proposed by the EC and adopted by the Council in 2006, requires the satisfactory performance in meeting all obligations stemming from the countries SAA. Subject to the satisfaction of these obligations, and upon formal request of the aspiring country, accession negotiations are ready to begin.

Maastricht Criteria

The Werner Report of 1970 represents the first official step towards the Economic and Monetary Union proposing a three-step strategy within 10 years. This included stabilization and narrowing of the fluctuation margins between currencies of the member states, complete freedom of capital movements, and an irrevocable fixing of the exchange rates between the participating national currencies (Faulend *et al*., 2005). In 1979, a European Monetary System was built on the concept of a stable but adjustable exchange rate defined in relation to the newly-created European Currency Unit (ECU). An exchange rate mechanism (ERM) was created which allowed fluctuations around central rates. Formally, the implementation of EMU dates 1988 as stated in the Delors Report, requiring for amendments to the Treaty. This led to the Treaty on European Union, formally adopted by the Heads of State and Government at the Maastricht European Council in December 1991. The Treaty of Maastricht provided three stages for EMU:

- Stage 1 (from 1 July 1990 to 31 December 1993) – free movement of capital between member states;
- Stage 2 (from 1 January 1994 to 31 December 1998) – economic policies co-ordination and stronger central bank co-operation;
- Stage 3 (underway since 1 January 1999) – gradual introduction of the euro[1] as the single European currency for the member states, and implementation of the common monetary policy by the European Central Bank. Participation in the third stage of EMU and the adoption of Euro as a single currency requires the fulfillment of the convergence criteria as provided in the Art. 140 of the Treaty of Maastricht.

1. *Price stability criteria.*

The first indent of Article 140 of the Treaty requires *"the achievement of a high degree of price stability; this will be apparent from a rate of inflation which is close to that of, at most, the three best performing Member States in terms of price stability*". Article 1 of the Protocol No 13 on the convergence criteria stipulates that "*the criterion on price stability referred to in the first indent of Article 140(1) of the Treaty on the Functioning of the European Union shall mean that a Member State has a price performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than*

1½ percentage points that of, at most, the three best performing Member States in terms of price stability. Inflation shall be measured by means of the consumer price index on a comparable basis taking into account differences in national definitions". The average inflation rate is measured by the percentage change in the un-weighted arithmetic average of the last 12 months' indices relative to the un-weighted arithmetic average of the 12 monthly indices of the previous period, rounded to one decimal place. Considering an average value of the three best performing states allows consideration of the effects on inflation rates across member states of common shocks. EC practice suggests that countries which inflation rates are significantly below/over comparable rates in other member states and those strongly affected by exceptional factors will be considered outliers.

2. *Public finances criteria: public debt and fiscal balance.*

Under EMU, there's no room for intervention in terms of monetary and exchange rate policy to smooth internal or external macroeconomic shocks. Thus, fiscal policy remains the only tool under a country's control to implement and maintain macroeconomic equilibrium. The EU convergence criteria related to the government budgetary position is defined in the second indent of Article 140 of the Treaty, which requires *"the sustainability of the government financial position; this will be apparent from having achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 126(6)"*. Article 2 of the Protocol stipulates that this criterion shall mean that *"at the time of the examination the Member State is not the subject of a Council decision under Article 126(6) of the said Treaty that an excessive deficit exists"*. To assess whether a member state has an excessive deficit two criteria for budgetary discipline are considered as set in Article 126:

(a) Whether the ratio of the planned or actual government deficit to GDP exceeds a reference value (specified in the Protocol as 3% of GDP), unless:

- *either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively,*
- *the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value;*

(b) Whether the ratio of government debt to GDP exceeds a reference value (defined in the Protocol on the excessive deficit procedure as 60% of GDP), unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

3. *Exchange rate criterion.*

Participation in EMU, like any other monetary union, entails technicalities such as the irrevocable fixing of member countries' exchange rates and elimination of cross-country exchange rates between member states. Thus, its long-term stability concerns the attained nominal and real convergence level, commitment and efforts of member states in adjusting economic policies into harmonization with those of the EU. Although not required, the catching-up process represents an important step towards EMU facilitating the adherence to the Maastricht criteria (De Grauwe and Schnabl, 2004). In order to avoid exchange rate manipulations and unfair competitive positions, nominal exchange rate convergence is required under the Maastricht criteria. The third indent of Article 140 of the Treaty requires *"the observance of the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System, for at least two years, without devaluing against the euro"*. Article 3 of the Protocol on the convergence criteria referred to in Article 140 of the Treaty stipulates: *"The criterion on participation in the exchange-rate mechanism of the European Monetary System referred to in the third indent of Article 140(1) of the said Treaty shall mean that a Member State has respected the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency's bilateral central rate against the euro on its own initiative for the same period."* After accession to the EU, membership to the ERM II can take place at any time and is voluntary for member states outside the euro zone. Also, an entering country, the euro area countries, and the ECB must agree on the central rate[2] and fluctuating band[3] around it. The reference value for the ER is not coincident with the conversion rate (the rate at which the national currency will be converted to the euro).

4. *Long-term interest rate criteria.*

The alignment of long-term interest rates between member countries represents the fourth economic convergence criterion. According to De Grauwe (2012), this criteria aims the prevention of capital gains on bonds issued by countries that paid a high premium due to exchange rate risks. If it is known that the exchange rate will be fixed, investors will sell low premium bonds (lowering their price and increasing interest rates on them) and will buy high premium bonds (increasing their price and decreasing interest paid on them). In countries with initial low interest rates, they will grow and holders of bonds will experience a capital loss; in a country with initial high interest rates, interest rates will fall and bond holders will have a capital gain. To avoid unfair capital gains/losses the fourth indent of Article 140 of the Treaty requires *"the durability of convergence achieved by the Member State with a derogation and of its participation in the exchange-rate mechanism being reflected in the long-term interest-rate levels"*. To monitor the fulfillment of this criterion, article 4 of the Protocol on the convergence criteria referred to in Article 140 of the Treaty stipulates: *"The criterion on the convergence of interest rates referred to in the fourth indent of Article 140 of the said Treaty shall mean that, observed over a period of one year before the examination, a Member State has had an average nominal long-term interest rate that does not exceed by more than two percentage points that of, at most, the three best performing Member States in terms of price stability. Interest rates shall be measured on the basis of long-term (10 years) government bonds or comparable securities, taking into account differences in national definitions"*. If a country does not have long-term government bonds or those present have no benchmark characteristics as required (EC, 2012), it is possible to consider comparable financial instruments, as in the case of Estonia (Faulend *et al.*, 2005), Luxembourg (EC, 2010) and Greece.

MACROECONOMIC CONVERGENCE

Convergence to Maastricht criteria will be carried out using the same framework as in EC official convergence reports for all the countries object of the study. The common framework consistently used to examine the state of economic nominal convergence, is based on the Treaty of Maastricht provisions and relative Protocols. Some important principles are followed when applying the convergence criteria[4]: *(i) the individual criteria are applied in a strict manner; (ii) the convergence criteria constitute a coherent and integrated package, and they must all be satisfied; (iii) the criteria have to be met on the basis of actual data; (iv) the application of the convergence criteria should be consistent, transparent and simple.* When assessing compliance to the convergence criteria, sustainability should be considered over a lasting basis and not at a given point in time. That's why, both a backward and forward looking perspective over a 5 years' period will be considered (more than that when data available). This approach would enable understanding on whether current achievements are the outcome of a genuine structural adjustment and not the result of short term maneuvers. As a cut-off date for the statistics considered in this study will be the end of June 2015.

…on price stability criterion

Price stability will be measured as changes in the unweighted average of last twelve months CPIs to the cutoff date compared to the same period the previous year. For each of the countries considered in this study data on consumer prices have been provided from the respective statistical offices. From the methodological point of view, all the data on consumer prices comply with COICOP methodology, largely in line with EU requirements and standards. Kosovo and Montenegro release the harmonized indices of consumer prices (HICP). The other countries produce indices of consumer prices in accordance to the COICOP which are not fully comparable with the harmonized ones.

From 2005, the Balkan countries have been characterized by relatively low inflation rates. However, annual inflation dynamics have been subject to high sensitivity of the domestic economy to shocks in prices in foreign markets, changes in administered prices, volatility in food prices (still accounting for a significant share of the consumer's expenditures) and other country specific factors.

Table 2. Summary of data used for price stability assessments.

	Indicato r	Period	Frequenc y	Methodolog y	EU harmonized	Source
Albania	ICP	2005/ 2015	Monthly	COICOP	No	Albanian National Institute of Statistics www.instat.gov.al
Serbia	ICP	2009/ 2015	Monthly	COICOP	No	Serbian Statistical Office http://webrzs.stat.gov.rs/Web Site/
Kosovo	HICP	2005/ 2015	Monthly	COICOP	Yes	Kosovo Agency of Statistics http://ask.rks-gov.net/ENG/price/cpi-tables
Montenegr	HICP	2011/	Monthly	COICOP	Yes	MNE Statistical Office

o		2015				http://www.monstat.org/eng/page.php?id=25&pageid=25
FYROM	ICP	2006/ 2015	Monthly	COICOP	No	State Statistical Office http://www.stat.gov.mk/Default_en.aspx
BiH	ICP	2006/ 2015	Monthly	COICOP	No	BiH Agency for Statistics: http://www.bhas.ba/?lang=en

Financial markets turmoil in 2008, coupled with the sovereign debt crisis in some EU countries – Balkan main trading partners – intensified uncertainties in the real sector of the economy. Inflation intensified during this period in almost all of the countries considered. The data show that respective central banks have been able to adopt forward – looking policies and timely decisions in order to attain and maintain price stability, with the exception of Serbia. Serbia, Montenegro, Albania, Kosovo and BiH are all small opened economies to international developments, and it is almost impossible to account for all the external shocks that may occur and could affect the domestic inflation rates.

As stated on the convergence criteria, the average rate of inflation, observed over a period of one year before the examination should not exceed by more than 1½ percentage points that of, at most, the three best performing Member States in terms of price stability. The three best performing countries in terms of price stability as by the cutoff date of June 2015 are Estonia (1.09%), Austria (0.97%) and Lithuania (0.79%). The average rate of inflation with regard to the best performing countries is 0.95%. The reference value for price stability assessments is 2.4%. Inflation rate in Albania over July 2014 – June 2015 resulted 1.7%, about 0.7 percentage points below the reference value. For the same period, inflation rate of Serbia resulted in about 1.6%. All the other countries present inflation rates quite below to the reference rate as by the cutoff date. *Thus, it would be concluded that Albania and Serbia (despite methodological issues) fulfill the price stability criteria as specified by the Maastricht Treaty and following protocols. Kosovo presents and inflation rate of about 0.1% which is quite below the reference value. As by the Maastricht Treaty requirements, we might conclude that Kosovo also fulfills the price stability criteria (fully harmonized HICP and below the reference value).* But, is such a low inflation rate e suitable for the Kosovo economy (where there are still large structural changes taking place)? Might the low inflation rate depress the overall economy? To note that the Central Bank of Kosovo, has as a principal objective to *"foster the soundness, solvency and efficient functioning of a stable market based financial system, encouraging market emergence of safe financial instruments; and without prejudice to this, support the general economic policies in Kosovo with a view to contributing to an efficient allocation of resources in accordance with the principles of an open market economy* (http://bqk-kos.org/index.php?m=t&id=3)". Thus, price stability is not an objective *per se* of the Central Bank of Kosovo.

Table 3. Price stability criterion assessments

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
HCPI [1]	**2.7**	**2.7**	**2.9**	**4.7**	**3.5**	**1.2**	**2.9**	**3.0**	**2.3**	**0.7**	**0.1**
Euroarea[2]	**2.2**	**2.3**	**2.0**	**2.8**	**2.3**	**0.9**	**2.2**	**3.4**	**2.3**	**0.7**	**0.0**
Albania[3]	2.2	2.3	2.5	3.8	2.3	3.2	3.7	2.1	2.5	1.6	**1.7**
Kosovo[3]	-2.4	0.4	0.8	10.3	1.6	-0.4	7.6	3.3	3.0	0.6	**0.1**
Serbia[3]					10.3	5.5	10.6	6.7	10.8	3.3	**1.6**
Montenegro[3]							0.2	-0.2	0.2	-0.4	**0.1**
FYROM[3]	1.9		2.5	6.2	3.1	-0.5	3.6	2.9	3.9	0.9	**-0.3**
BiH			2.9	5.0	3.8	0.5	3.8	1.5	1.3	1.0	**-0.5**
Reference value[4]	**Best performing: [Average [Estonia (1.09); Austria (0.97); Lithuania (0.79)]=0.95] + 1.5%**										**2.4 %**

Source: Eurostat, National Statistical Offices of relative countries as specified in table.

[1] EU15 - 1995, EU25-2004, EU27-2007, EU28-2013.
[2] EA11-2000, EA12-2006, EA13-2007, EA15-2008, EA16-2010, EA17-2013, EA18
[3] Inflation rate for all Balkan countries is calculated as the annual changes of un-weighted average of CPI over the past 12 months to the cut-off date (end of June 2015). Reasoning is the same for all previous periods.
[4] For the period July 2014 - June 2015 the three best performing countries resulted to be Estonia +1.09%, Austria +0.97% and Lithuania +0.79. The simple average of the three best performing members was 0.95%. Reference value is calculated as the sum of the average of the three best performing countries plus 1.5 percentage points.

The Former Yugoslav Republic of Macedonia and Bosnia Herzegovina both present negative inflation rates over the considered period. *Since disinflation is not a desired outcome, we conclude the both of these countries do not fulfill the price stability criteria. Montenegro too does not fulfill the price stability criteria.*
However, we should bear in mind that the convergence of national average prices to EU average prices is a long-term process not only in transition countries but even in established member countries. Another very important point is that the price stability criterion represents a moving target; the reference value is not fixed (Boka & Torluccio, 2003). Therefore, attaining and maintaining price stability requires strong efforts and commitment of the central bank.

…on fiscal criteria
The sustainability of the governmental financial position requires the ratio of government deficit to GDP below the reference value of 3% and the ratio of public debt to GDP not to exceed the reference value of 60%. To assess fiscal criteria convergence, consolidated

budget statistics should be compiled in accordance with Eurostat ESA 95 methodology. EU 28 member states have completed the harmonization of their methodologies to ESA 95 and are adjusting to ESA 2010. From September 2014, ESA 2010 was published and data transmission from Member states to Eurostat is following ESA 2010 rules.

With regard to Balkan countries, Montenegro and Kosovo are gradually moving to implement the Government Finance Statistics Manual (2001) and trying to comply with ESA 2010 methodology. The same is valid for Serbia which also is working on adjusting methodologically to ESA 2010. BiH and FYR Macedonia compile and present data in accordance to IMF's Government Finance Statistics Manual 2001. In Albania, the compilation methodology underlying the data for the consolidated budget is broadly consistent with the analytical framework set out in the "Government Finance Statistics Manual, 1986 (GFSM)". Presentation and classification are not in the GFSM format. Future plans concern the adoption of the methodology of the IMF's "Government Finance Statistics Manual, 2001" (GFSM 2001). The classification debt data mostly comply with the international standards indicated in the IMF's "Public sector debt statistics-Guide for compilers and users 2011".

Returning to the main question: do the Balkan countries fulfill the fiscal criteria related to fiscal balance as percentage of GDP? According to the data, BiH and Kosovo are the only one to have maintained fiscal deficit below the 3% threshold imposed by the Maastricht criteria (projected data). All the other countries are projected to overshoot the target especially Montenegro. What is important to stress is that all of the Balkan countries have been facing different structural economic and social challenges and the fiscal deficit has been volatile among years. Furthermore, countries are expected to adopt fiscal discipline and bring the fiscal balance to GDP ratio within the target imposed by the Maastricht Treaty fiscal criteria. The path seems tougher for Montenegro, which projects to bring under control fiscal deficit from -10.0% in 2015 to -8.8 in 2016 and -3.2% in 2018.

Table 4. General government fiscal balance (percent of GDP)

	Albania	Bosnia and Herzegovina	Kosovo	FYR Macedonia	Montenegro	Serbia	Reference value
1998	-9.3	-1.0	n/a	-1.6	n/a	n/a	
1999	-8.3	-2.8	n/a	0.0	n/a	n/a	
2000	-7.4	-4.6	1.9	2.4	n/a	-0.2	
2001	-6.6	-3.5	4.3	-5.9	n/a	0.4	
2002	-6.1	-3.0	3.8	-5.2	-1.4	-2.6	
2003	-4.9	-0.1	1.6	-0.1	-4.0	-2.7	
2004	-5.1	-0.4	-4.6	0.4	-2.4	0.1	
2005	-3.4	0.4	-3.1	0.2	-1.4	1.1	
2006	-3.2	2.2	2.7	-0.5	3.2	-1.0	
2007	-3.2	0.5	7.0	0.6	6.3	-0.9	
2008	-4.9	-3.2	-0.2	-0.9	-3.2	-1.9	
2009	-6.6	-5.4	-0.6	-2.6	-5.4	-3.6	**3**
2010	-3.5	-4.1	-2.2	-2.4	-4.6	-3.7	
2011	-3.5	-2.8	-1.8	-2.5	-5.3	-4.1	

2012	-3.4	-2.7	-2.6	-3.8	-5.9	-6.8	
2013	-5.2	-1.9	-3.1	-3.9	-5.2	-5.3	
2014*	-5.4	-3.0	-2.6	-4.2	-1.3	-6.3	
2015*	**-5.1**	**-1.6**	**-2.6**	**-4.0**	**-10.0**	**-3.9**	
2016*	-4.2	-1.5	-1.8	-3.8	-10.1	-3.8	
2017*	-2.8	-1.2	-1.7	-3.5	-8.8	-3.0	
2018*	-3.0	-0.8	-1.6	-3.5	-3.2	-2.2	
2019*	-3.2	-0.4	-1.8	-3.5	-1.3	-2.1	
2020*	-3.0	0.0	-1.9	-3.5	-1.3	-1.9	

Source: IMF, World Economic Outlook Database, October 2015.*Projections start from 2014.

The sustainability of the governmental financial position requires ratio of public debt to GDP not to exceed the reference value of 60%. Despite methodological disparities, Balkan countries have been experiencing an increasing public debt trend especially over the last decade. The latter might be related to the big infrastructural projects implemented and structural changes facing in their economies.

In the medium term, the consolidation path is expected to bring down public debt to GDP ratio. Public debt is expected to mark 72.2% of GDP at the end of 2015, 71.3% in 2016 and 69.2% at the end of 2017. Debt contraction is expected to be achieved despite significant energy related guaranties taken into account in the medium term.

Table 5.General government gross debt (percent of GDP)

	Albania	Bosnia and Herzegovina	FYR Macedonia	Kosovo	Montenegro	Serbia	Reference value
1997	70.0	n/a	n/a	n/a	n/a	n/a	
1998	67.8	54.4	n/a	n/a	n/a	n/a	
1999	65.0	56.0	29.8	n/a	n/a	n/a	
2000	61.9	34.7	45.6	n/a	n/a	224.8	
2001	58.5	35.2	45.2	n/a	n/a	106.3	
2002	62.8	31.2	40.5	n/a	75.7	76.1	
2003	58.8	27.6	36.5	n/a	40.3	71.8	
2004	56.5	25.5	34.6	n/a	41.6	62.2	
2005	57.4	25.5	36.7	n/a	36.3	54.1	**60**
2006	56.1	21.2	30.6	28.7	31.9	40.3	
2007	53.4	18.7	23.5	24.8	27.5	33.4	
2008	55.1	30.9	20.6	21.2	29.0	32.4	
2009	59.7	35.8	23.8	17.0	38.2	36.0	
2010	57.7	39.1	24.1	16.1	40.9	43.7	
2011	59.4	39.7	27.7	14.6	46.0	46.6	
2012	62.0	43.6	33.7	17.1	54.0	58.3	
2013	70.1	41.6	34.2	17.5	55.8	61.4	

2014	72.5	44.8	38.2	18.7	60.5	72.2	
2015	73.3	45.5	37.1	21.4	69.9	76.7	
2016	70.2	45.0	39.6	25.5	73.8	78.4	
2017	65.6	43.8	41.1	27.2	79.3	77.7	
2018	61.0	42.6	42.6	25.3	79.2	75.2	
2019	56.3	40.7	43.9	26.6	78.0	71.8	
2020	51.4	38.3	44.9	28.0	75.5	68.6	

Source: IMF, World Economic Outlook Database, October 2015.

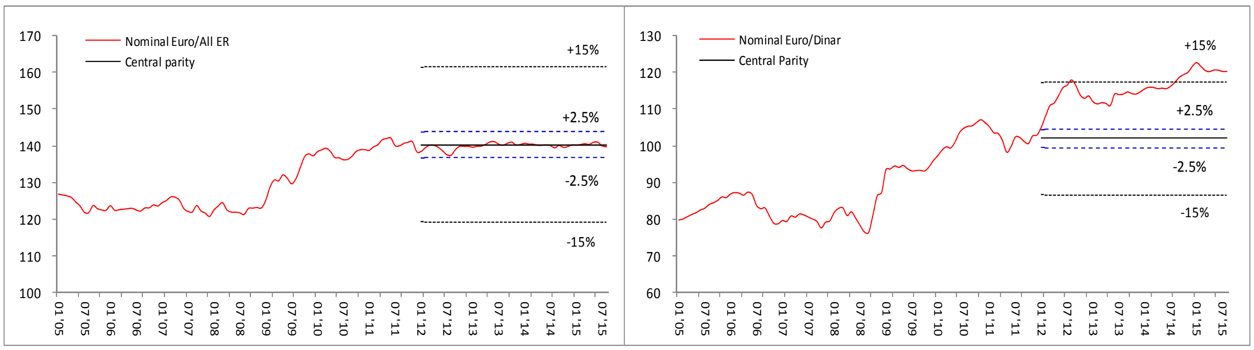
Kosovo and FYR Macedonia present the lowest debt to GDP ratios among the Balkan countries considered. Both of the countries might be considered as compliant with the Treaty requirements in terms of public debt to GDP. The same is valid for Bosnia Herzegovina. On the contrary, Albania, Montenegro and Serbia present the highest public debt to GDP ratios, thus overshooting the 60% threshold level imposed by the Treaty of Maastricht. Albania, despite the high level of public debt to GDP ratio projects to lower its level and be compliant approximately in 2019. Serbia projects to bring under control the public debt to GDP ratio at a slower pace from 2017. On the contrary, Montenegro public debt to GDP ratio is expected to increase progressively until 2017 and contract somewhat during the next three years. Nevertheless, it remains above the 60% threshold level.

…exchange rate stability criterion

The exchange rate stability criterion requires a successful participation in the ERM II, a multilateral agreement, for at least two years after the EU accession of the country (stability of the exchange rate against Euro and no unilateral devaluation). Thus, assessment for exchange rate stability criteria might be carried out only when Balkan countries will participate in ERM II. For the purposes of this study, we can only analyze ER fluctuations against Euro since its introduction. Of course, whether the exchange rate shows relative stability or not, we cannot conclude that the countries subject to this analysis formally fulfill or not the exchange rate criteria. An analytical assessment in relation to the exchange rate stability criteria requires the determination of a (hypothetical) central parity of currencies exchange rates against Euro.

De jure or/and *de facto*, euro played an important role in the Southeastern European countries since its introduction (Barisitz, 2007)due to strong trade and other relations with European countries. Despite all of the countries presenting strong relations to the common currency, Balkan countries have followed quite different policies in terms of exchange rate arrangements. Actually, Kosovo and Montenegro have adopted the euro as their legal tender (though unilaterally). Bosnia and Herzegovina have opted for currency board arrangements, with 1.95583 BAM for 1 Euro (or 0.511292 Euro for 1 BAM). *De jure*, the Republic of Macedonia has as legal tender the Macedonian denar (MKD) but *de facto* the exchange rate regime is pegged to the Euro. According to (IMF, 2013), Macedonia is classified under *"stabilized arrangements"* using Euro as nominal exchange rate anchor. Albania and Serbia are the only countries still presenting free floating exchange rate regimes. In Serbia, the Serbian dinar (RSD) is the legal tender and has opted for a floating exchange rate regime (IMF, 2013). The Bank of Albania (BoA) formulates and implements the monetary policy under a free-floating exchange rate regime[5]. Nevertheless, according to IMF (2013), Albania presents a floating regime with Albanian Lek as legal tender currency. The value of the national currency Lek (ALL) against foreign currencies is freely determined in the foreign exchange market by the interaction of supply and demand. Nevertheless, the Bank of Albania reserves the right to intervene in the foreign exchange market in presence of severe shocks aiming to safeguard stability and development of the domestic financial markets. Both in Albania and Serbia, Euro is widely used and accepted resulting in a high degree of euroisation of both economies.

Figure 1. Nominal ER Eur/All (lhs) and Nominal ER Eur/Dinar (rhs)



Source: Bank of Albania and National Bank of Serbia

With regard to the purpose of this study and in terms of exchange rate stability criterion we cannot make assessments for Montenegro, Kosovo, Bosnia and Herzegovina and Macedonia. In the case of Albania and Serbia, under certain assumptions on central parity and ERM II participation date, we can observe exchange rate fluctuations. Thus, we assume that Albania and Serbia would have participated in ERM II in July 2013 and assume that the central parity might be equal the average exchange rate over the 12 month period comprised from July 2012 to June 2013. Under this assumption we can make assessments on the stability of the Albanian Lek and Serbian Dinar exchange rate against Euro over the last two years.

At the beginning of 1999, the Eur/ALL exchange rate was set at 162.2 Lek per Euro (simple average for January 1999). After appreciating till 2001 (+11.8%), the national currency depreciated over 2002-2003 on the back of both appreciation of Euro against USD in international markets and confidence crisis in national currency during the first months of 2003[6]. From 2004 to 2008 a progressive appreciation of the national currency may be noticed, reflecting domestic macroeconomic stability, high inflow of remittances and foreign direct investments. The peak was reached in the aftermath of the global financial crisis of 2008 (122.8 Lek per Euro). Since then, Eur/ALL followed a depreciating trajectory over the next couple of years. From 2012, apart from seasonal factors, Eur/Lek exchange rate fluctuated between narrow limits of 139 – 140 on average, showing a relative stability.

Due to important challenges faced from the Republic of Serbia in recent years, exchange rate volatility over time has been high. Aiming the protection of the fragile external accounts and smooth somewhat the strong real appreciation tendency emerged after lunching the dinar tightly managed float in 2000, the NBS tried to loosen the dinar's float at the beginning of 2003. Over the next three years, the Serbian dinar depreciated nominally by a cumulative 40% against euro (Barisitz, 2007) but in real terms little changed. VAT introduction in 2005, continuous adjustments to administered prices and high fuel imports led to a deterioration of the situation. High inflow of remittances, FDI related inflows and higher export led to a depreciation of dinar over time. From 2012, apart from seasonal factors, EUR/Dinar exchange rate has been quite volatile, with dinar experiencing a depreciating trend over time. The exchange rate fluctuated between relatively wide limits of 113 – 120.8 on average, falling outside the narrow and wide tolerance intervals suggested by the ERM II.

…long-term interest rates convergence criteria

Long term interest rates indicate markets agent's inflation expectations and financial markets integration level. Low interest rates, suggesting for low inflation expectations and low risk premium, signal for potential stable and sustainable future economic growth. Long term interest rates convergence criteria assessment requires using long term government bonds (with 10 years residual maturity) issued in national currency. As by the first half of 2015, the instruments issued by the Albanian government, include treasury bills (3, 6 and 12 months' maturity); bonds (2, 3, 5, 7 and 10 years' maturity). From the methodological point of view, none of the instruments issued by the Albanian government is comparable those required to assess for nominal convergence of interest rates. Skipping the methodological aspects, as by the sample approach, 10 year bonds might be used to some extent. The 10-year maturity bonds were firstly issued in October 2013 and have regular quarterly frequency. Although not meeting the requirements of the Treaty and the availability of a short time series we try to make some compliance assessments using it as a benchmark interest rate for Albania. In the case of Kosovo, 12 month Treasury bills have not been issued regularly and 5 years government bonds have been issued only once. Serbian government issues treasury bills and bonds both in local and foreign currency. For the instruments issued in Euro there is not a regular frequency. Montenegrin government issues only short term treasury bills, thus not suitable to our purposes. Instead, for Bosnia and Herzegovina no data were available. The Macedonian government issues 5 and 10 years bonds, though not regularly.

Table 6. Long term interest rate assessments

Best performing countries in terms of price stability	Interest rate: EMU convergence criteria	12M T-Bills	5Y Bonds	10Y Bonds	15Y Bonds
Bulgaria*	2.9				
Lithuania	2.4				
Austria	0.9				
Average	2.0				
Reference rate	**4.0**				
Albania		3.4	6.6	9.2	na
Kosovo		1.7	4.9	na	na

Serbia – local currency		8.0	10.8	11.7	12.9
Serbia – in Euro		2.4	4.9	5.5	na
Montenegro	Only short term T-Bills 182 days				
Bosnia and Hercegovina	na				
Macedonia			3.7	4.4	4.0

Source: Bank of Albania, Central Bank of the Republic of Kosovo, National Bank of Serbia, Central Bank of Montenegro, Central Bank of Bosnia and Herzegovina, National Bank of the Republic of Macedonia.
*Best performing countries in terms of price stability as by June 2015 are Austria, Lithuania, and Estonia. Since there are no data on interest rates for Estonia we consider the fourth best performing country in terms of price stability, Bulgaria.

With regard to Maastricht Criteria requirements, none of the countries subject to this analysis presents the adequate financial instruments to meet the Treaty requirements and neither exists other comparable instruments to be considered. Actually, Balkan countries financial markets are quite underdeveloped which makes it difficult to find alternative financial instruments. The Albanian government demand for financial resources is oriented to domestic markets, issuing treasury bills (1Y T-Bills) as the main instrument. Recently, bonds with longer maturities were issued but, none of them meet the Treaty requirements and neither exist other comparable instruments to be considered. Thus, if we account for 10Y bonds, interest rates are significantly above the reference rate. The same stands for 5Y bonds. The same result for Serbian government bonds in local currency. Government bond issued in euro present lower interest rate but they are issues occasionally and do not meet the Treaty requirements. For Macedonia, skipping the methodological aspects, we can make some assessments in relation to long term interest rate criteria. The government bond interest rates seem to be close to the reference rate for all the maturities.

CONCLUSIONS

The main objective of this paper was to present Balkan countries current stage of compliance to Maastricht (nominal) convergence criteria. All the indicators considered are not methodologically harmonized with those of EU member countries (with few exceptions), and thus are not fully comparable with them.
Bearing in mind the methodological differences we conclude that: (i) Albania and Serbia (despite methodological issues) fulfill the price stability criteria at the cut-off date. Kosovo also fulfills the price stability criteria (fully harmonized HICP and below the reference value). Macedonia and Bosnia Herzegovina both present negative inflation rates thus these countries do not fulfill the price stability criteria. (ii) Albania does not fulfill the fiscal criteria on fiscal deficit and public debt at the cut-off date. Bosnia and Herzegovina and Kosovo have maintained fiscal deficit below the threshold level. All the other countries do not fulfill this criterion. Also, there's a weak methodological alignment to the international standards for fiscal accounts. With regard to public debt to GDP ratio, Macedonia, Kosovo and BiH present the lowest ratio among the region. On the contrary, Albania, Serbia and Montenegro present the highest public debt to GDP rations thus overshooting the 60% level, (iii) Exchange rate stability assessments cannot be make at the current stage of things. Nevertheless, Albanian lek has been relatively stable against

Euro but no assessment can be done prior fixing a central rate. On the contrary Serbian dinar presents a high volatility against Euro, (iv) long term interest rate criteria assessment could not be carried out as required since no benchmark data could be found.
Given the above considerations, as recommendations we suggest: (a) strong efforts of Balkan countries should be directed towards harmonization and methodological improvements on statistics with those used by Eurostat, and (b) further research in the medium-term is needed to be conducted on Balkan countries real convergence.

References

Barisitz, S. (2007). *Exchange Rate Arrangements and Monetary Policy in Southeastern Europe: An Update (2004–2007)* (Focus 2/0 7 ed.). Oesterreichische Nationalbank.

Boka, M., & Torluccio, G. (2003). *European Integration Process: Where is Albania?* (Vol. 2). Academic Journal of Interdisciplinary Studies, MCSER Publishing-Rome,Italy.

De Grauwe, P. (2012). *Economics of Monetary Union.* USA: Oxford University Press, 9 edition.

De Grauwe, P., & Schnabl, G. (2004). Nominal versus real convergence with respect to EMU accession - EMU entry scenarios for the new member states.

Faulend, M., Loncarek, D., Curavic, I., & Sabic, A. (2005, July*). EU criteria with special emphasis on the economic convergence criteria - Where is Croatia?* Croatian National Bank .

IMF, International Monetary Fund (2013). *Exchange Arrangements and Exchange Restrictions 2013.* International Monetary Fund.

EC (European Commission). 2010. Convergence Report 2010.

EC (European Commission). 2012. Convergence Report 2012.

http://ec.europa.eu/enlargement/countries/check-current-status/index_en.htm

http://europa.eu/legislation_summaries/enlargement/ongoing_enlargement/l14536_en.htm

http://www.europarl.europa.eu/summits/mad1_en.htm