Defining a New Reform Agenda
Paths to Sustainable Convergence in South East Europe

Edited by Othon Anastasakis, Peter Sanfey and Max Watson
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Acknowledgements

This book had its origin in a series of seminars organised jointly by SEESOX and the Bank of Albania over the past two years, in the context of their ongoing co-operation agreement. The main chapters are based on papers and presentations made by the authors at these events. The organising themes of the volume emerged from the associated process of analysis and discussion, as well as from workshop reports.

We would particularly like to thank our counterparts at the Bank of Albania for their enthusiastic support of this project, as well as for their direct contributions to the book and to the thinking behind it. A number of informal meetings with Governor Fullani and officials of the Bank were crucial in helping to inspire the project and bring it to fruition. To the extent that there is a fresh vision of the region and its future in this volume, the genesis of that vision stems at least as much from Tirana as from Oxford. The programme of research and discussion also benefited greatly from discussions with the network of central banks in the region, including the Central Bank of Bosnia and Herzegovina – which has recently entered into a co-operation agreement with SEESOX – and the Bank of Greece, with whom there are long-standing ties of co-operation. One of the contributors to the project, Fikret Causevic, was an Alpha Bank Visiting Fellow at Oxford during the process of writing and editing of the volume. The EBRD was generous in supporting Peter Sanfey’s engagement with the project, as well as contributing to the costs of bringing foreign seminar participants to Oxford. Irem Guceri made an invaluable contribution by distilling the key messages from seminars, and helping to prepare the associated reports.

Special thanks should also go to Julie Adams, the Administrator of SEESOX, for shepherding this book through the demanding process of publication, as well as organising the events that laid a basis for the work that it presents.
Working with these collaborators has been a great pleasure, and we believe that this has resulted in a volume that will contribute to academic and policy thinking about the future of the region. Needless to say, all views presented here are those of the authors, and do not in any way commit the institutions with which they are associated.

The editors
November 2012
Introduction

Since the onset of the Euro area crisis, the politico-economic challenges facing South East Europe have evolved, even though many of the underlying issues have roots deep in the past. Politically, the crisis has weakened the EU’s role as an anchor and as a model, intensifying concerns as to how the accession process can be fully effective in these countries. Economically, the troubled outlook for growth in the EU heightens an already recognised need to make the region, as an economic space, attractive and competitive in global markets. Tackling these problems means coming to terms with politico-economic weaknesses that persisted across the region even during the growth spurt of the past decade. How to address these issues, laying deeper foundations for growth and for regional security in a wider sense, is the topic of this volume.

In South East Europe, the first decade of transition was marked by a slow, and in some cases negative, start. In many cases, old-fashioned, former communist elites dominated the political environment, resisting reform and market economics, pursuing illiberal practices, and leading their economies to serious crises. Bulgaria and Romania suffered acute economic setbacks in the mid-1990s; Albania saw the collapse of the pyramid scheme followed by social anarchy; Serbia went through a decade of economic mismanagement and moments of hyperinflation; and Bosnia and Herzegovina, as well as Kosovo, became war economies. Against a tide of European integration and liberalisation which dominated the rest of Europe, South East European economies all too frequently went backwards, witnessing clientelistic and corrupt privatisations, and the capture of the state and newly established institutions. During this first phase of post-communist economic change, the priorities and involvement of external and global actors were, in the majority of cases, dominated by security and non-developmental considerations.

In the 2000s, with the end of ethnic conflicts in former Yugoslavia and the coming to power of more democratic and moderate governments, the region witnessed rapid growth, rising public expenditure, capital inflows from abroad, a normalisation of politics, and the role of the EU as an anchor. This was a time of increasing attractiveness for investment in the bigger markets of Bulgaria, Romania or Serbia; of EU accession for Bulgaria and Romania; and of
EU stabilisation and association for the Western Balkans. Strong neighbouring EU member states, like Italy, Austria and Greece, were investing heavily in the Balkans, in the banking, infrastructure and telecommunication sectors. Politics in the region became less nationalistic and much less extreme, based on EU consensus and the beliefs in the transformative power of the European Union.

But was this the right growth model for the economies of South East Europe? In the period between 2000 and 2008, the region’s economies enjoyed a mini-boom, strongly fuelled by large inflows of international finance in the form of bank credits and sizable remittances, enabling increased domestic borrowing by both firms and households, and a culture of consumerism based on imports and increasing current account deficits. Thus, the growth model of the 2000s was a model of numeric increase – but not one of a sustainable growth. This reality became all-too-clear during the current crisis. Following a decade of peace, stabilisation and relative prosperity, the global, banking and sovereign debt crisis is having a particularly severe impact on the Balkan countries, which are struggling to cope with its effects. The European Union is consumed by its own domestic Euro area crisis; the will for enlargement is waning; the leverage of conditionality is decreasing; while two main EU partner countries of the region – Greece and Italy – have been at the heart of the European recession.

The impact of the economic crisis in the Balkans can be perceived in two ways, depending on whether one wants to see the glass as half-empty or as half-full. On the pessimistic side, the crisis brought the economic growth of the previous decade to a halt, and – among the many adverse socio-economic consequences – we are witnessing rising unemployment and increased levels of poverty in the region. About one-quarter of the total workforce in the Balkans is unemployed, which is way above the European average. As a result, some of the countries are seeing the rise of populist governments and protest politics. Economic indicators have not yet recovered to pre-1989 economic levels, leading some to experience nostalgia for the communist era.

The most pessimistic argue that transition as a process of change towards democracy and market economy has largely failed, because it created expectations, worked on false premises, followed the wrong recipes, and led to deceptive growth, currently revealing its real face of external dependency, fiscal austerity and democratic regression. Even Slovenia, the miracle of transition with a stable government since the early stages of change, is showing signs of economic vulnerability. And Croatia, the next member of the European Union, will be entering the club as an economy under stress in 2013.

On the other hand, which is more positive, there are some reasons not to despair. The region has escaped a massive breakdown from the collapse of neighbouring Greece and the sudden reduction of Foreign Direct Investment (FDI). It has maintained some positive growth; its banking system has survived. Despite plunging incomes, rising poverty and increasing
unemployment, the incidence of social unrest in the region has thus far been limited, and setbacks to democracy have also been relatively limited. For example, despite intense economic and social distress, Serbia held peaceful and trouble-free parliamentary and presidential elections and witnessed a problem-free change of government. While there have been disturbances and falls of governments, protests by the general population and special-interest groups in almost every other country in the region, overall social peace has been maintained and there has been a remarkable absence of significant unrest.

Whatever the assessment, negative or more positive, there is a common realisation that the balance is delicate, that things can get worse, and that these economic stresses can be combined with the dormant conflicts in the former Yugoslav territory. It is predicted that the current crisis will last for a while, and that it will probably take different forms, and that the European perspective for those still outside the EU will become more distant and uncertain. While this in itself is a worrying prospect, it could – and this is one of the messages of this book – stimulate these countries to strengthen their domestic anchors and realise the advantages of regional cooperation and synergy.

In this light, the crisis could be an opportunity to reconsider alternative ways of strengthening South East Europe’s economies and fostering more effective development strategies for the future. But how is the challenge of restoring sustainable growth in South East Europe to be met? This is the key question addressed by the authors of this volume, as they consider the medium-term outlook in South East Europe. They recognise the huge dilemma posed by the two successive shocks that have struck the region – the global crisis, and then the sovereign and banking crisis in the Euro area. These crises have put in question not just the future pattern of growth, but also the nature and strength of the anchor that the EU and the Euro have offered to economies in the region. In light of these developments, the authors explore the options available to policymakers as they strive to re-launch growth on a more sustainable footing.

The broad implication of the shocks resulting from the crisis emerges clearly from these pages: the rates of growth which characterised a ‘golden decade’ up to 2008 are not about to resume. Banking inflows will be modest in scale. If that was not clear after the Lehman Bros shock in September 2008, today’s on-going financial stress and deleveraging in the Euro area leave no room for doubt. Other sources of foreign savings need to be found, with FDI being the main candidate. Moreover, the drivers of growth must shift away from consumption and residential investment towards exports, because current account deficits may need to be modest in the period ahead.

Measuring up the nature and scale of the challenge, the authors adopt different approaches. In Chapter 1, Boris Begovic sketches the politico-economic context of South East Europe. Begovic emphasises that even the growth achieved in the past decade implied only a modest pace of economic
catching-up. Moreover, the initial productivity gains of transition have now been realised. Continuing growth will require a better use of human resources, and it will mean enhancing total factor productivity in a more durable manner. Raising capital inputs will be a challenge unless FDI is encouraged and higher domestic savings are mobilised.

According to Begovic, the main constraints on growth are deeply politico-economic in nature. Progress has been hostage to a range of political factors – including security problems, vested interests, and nostalgia for the former socialist system. Such factors have impeded reforms that would improve the business environment. Thus, economic institutions have failed to support entrepreneurship and innovation; and economic activity in the region has remained worryingly tilted towards rent-seeking activities. The challenge now is whether the double wave of crisis in Europe can serve as a stimulus for higher saving and for deeper institutional reforms.

The authors of Chapter 2 – Peter Sanfey and Simone Zeh – highlight the urgency of reforms to attract FDI and foster export-oriented growth. They sift through a wealth of competitiveness and business environment indicators to distil targeted reform messages. The World Economic Forum’s Global Competitiveness Index signals some similarities across the region, with strengths in macroeconomic stability, but common weaknesses in workforce skills and innovation. More cross-country variation is signalled by the World Bank’s Doing Business reports. These pick up the progress achieved in Macedonia and Montenegro in creating an easier environment for starting up and operating a business, contrasting it with continuing weakness in Bosnia and Herzegovina. Business surveys such as the EBRD/World Bank Business Environment and Enterprise Performance Survey, these two authors note, also show up marked cross-country differences. Clear common themes emerge – corruption, weak tax administration, and the lack of a skilled workforce. Sanfey and Zeh finally comment in detail on several crosscutting themes that are leitmotifs in this volume – including the role of institutions, the obstacles to cross-border trade, the need to enhance skills, and the scope for regional co-operation in areas such as infrastructure.

In Chapter 3, Bas B. Bakker and Jesmin Rahman take as a starting point the need for a more sustainable pattern of growth in South East Europe, and in this connection they focus specifically on the issue of export orientation in the region. While these are in many other respects quite open economies, their export levels compare unfavourably with earlier accession countries in Central Europe, shedding light on their different pattern of integration. When more sophisticated measures of export openness are examined, this conclusion is reinforced.

The source of the problem, according to Bakker and Rahman, lies to a considerable degree in domestic policies. Business environment policies are one key area of concern. These have slowed the pace of integration in the traded goods sector – and in this regard progress on the EU Accession road seems to be an irreplaceable anchor. Macroeconomic policy frameworks,
however, also need to be reconsidered. By dampening future boom-bust cycles, these frameworks could help avoid a run-up in wage costs that is hard to reverse and damages competitiveness.

Chapter 4, by Fikret Causevic, discusses financial constraints on investment and growth in the wake of the global and Euro area crises. He explores how credit constraints have emerged across the region, after a period of strong credit expansion during the past decade. Unlike the situation three years ago, access to finance is now a key concern. This reflects in large part the dominance in these economies of banks headquartered in the Euro area, which are themselves experiencing stress in their domestic operations. With ongoing deleveraging in Euro area banking systems, and high or rising levels of non-performing loans in the region, the days of ample cross-border banking flows will not soon return, he concludes. Moreover, despite sharp external adjustment, South East Europe’s countries have significant levels of external debt. These capital account considerations reinforce the case for attracting FDI, including as a stimulus for export-led expansion. Innovations in domestic financial markets are also called for to help foster sustainable growth.

Thus far, South East Europe has lagged behind Central Europe and the BRICs in the quantity and quality of FDI it has attracted, and it has failed to emulate the pattern of deep economic integration with the EU that has been achieved in Central Europe. In Chapter 5, Ardian Fullani and Altin Tanku explore the urgency of revitalizing the region’s appeal to foreign investors. Survey data, they note, indicate that South East Europe is perceived among investors as a potentially favourable base for manufacturing, also due to its low labour costs. The drawbacks, from an investor’s perspective, include issues that need to be addressed at the regional, as well as the national, levels: issues concerning the size of the market and the adequacy of infrastructure networks. At the same time it is desirable to move towards a more knowledge-based economy, identified with stronger Research and Development, better commercialisation of research, and hence a greater capacity for innovation.

In all these respects, the authors argue, a co-operative effort at the regional level holds overwhelmingly the best chances of success. Currently, the region is seen as fragmented – with common failings, but a multiplicity of differing regulatory frameworks and poor inter-market links. Industries are concentrated in a few national nodes, and are not in high value-added sectors. Thus, there is a lack of true economies of scale and clustering of activities. This setting, moreover, tends to foster ‘growth competition’ rather than ‘growth co-operation’, with a duplication of efforts in research, and poorly co-ordinated development of human skills. Shifting to a new growth model, with a strong regional dimension, is all the more important in light of ongoing globalisation and the Euro area crisis. The region needs to develop domestic policy anchors, and it needs to compete for global capital – looking beyond Europe as it seeks sources of investment, financing and export market growth.
The authors of this volume thus reach consistent conclusions about the impact of the crisis on the region, and the desirable agenda for policy. They underscore that the pattern of growth in the past decade was unbalanced, and there will be no return to the banking inflows that underpinned it. They also share a working assumption that the EU’s role as an anchor and a model – while it is ultimately irreplaceable – has been impaired for a considerable period, and that the region is now thrown back more on its own resources. This storm bodes political dangers, given the recentness of security problems and of political instability. Yet the clouds could also have a silver lining, stimulating reforms that are long overdue, and fostering the development of stronger domestic anchors for policy. Moreover, a new strand is prominent in these diagnoses for change in the region: such reforms cannot make a decisive difference if they are pursued in a narrow national perspective. They need to help create a genuine regional economic space. Only such a space would truly stimulate economic development and attract foreign investors – not only from Europe, but also from the most dynamic parts of the world’s economy.
Chapter 1. The political economy context of economic growth in South East Europe

Boris Begović

Introduction

Economic underdevelopment of the region of South East Europe (SEE) has been its hallmark for decades. It is no surprise that one of the seminal articles of the theory of economic development (Rosenstein-Rodan, 1943) was staged in SEE, as an “international depressed area”. Over the last century, there has been no real convergence of SEE towards Western European living standards; the income per capita difference between the two regions has even increased. Obviously, the issues surrounding long-term economic growth are of particular relevance for the region.

The aim of this chapter is to explore the political economy context of this issue of potential growth, i.e., long-run growth of potential GDP in the countries of SEE, abstracting from the current cyclical position of the economies. Specifying such a political economy framework of economic growth could be useful for the treatment of the specific issues of the growth and economic reforms in SEE countries, with a view to shedding more light on the future of the region.

1 I am grateful to the editors, Laza Kekić, and Marko Paunović for their useful comments and suggestions. None of the above is responsible for possible remaining mistakes and expressed value judgments.

2 The region of SEE includes: Albania, Bosnia & Herzegovina, Bulgaria, Croatia, FYR of Macedonia, Montenegro, Romania and Serbia. The disputed territory Kosovo is also included in the region. Although Greece is geographically and by many other features a country of the region, due to the fact that it has never been a transitional economy and due to its long-standing membership in the EU, is not considered as part of the region in this paper. The other region of transitional economies, Central and East Europe (CEE) includes: the Czech Republic, Hungary, Poland, Slovakia and the Baltic republics (Estonia, Latvia and Lithuania).

3 Even though the author considers SEE together with East Europe as a single region: “everything between Germany, Italy and Russia”.

4 According to Maddison (2007), Western Europe per capita income was 2.04 times higher than the per capita income of Eastern Europe in 1913. This ratio increased to 3.07 in 2003. Although there is no separate calculation for the SEE, it can be assumed that the ratio is even higher, particularly taking into account that Greece is considered as part of Western Europe.
The methodological framework of this analysis is standard economic growth theory. The sources of growth are the accumulation of production factors and the increase in their productivity due to improved technology or enhanced efficiency. The sources of growth in SEE countries and their sustainability will be examined within the framework of political economy, and a few hypotheses will be proposed.

Recent trends in growth dynamics demonstrated that growth rates in SEE have not been spectacular by the standards of the most successful emerging market economies. Although the average annual growth rates in the last ten years (Table 1.) are higher than the growth rates of the EU15 countries (hence some real convergence has been recorded in the last decade), they are still below the average annual growth rates recorded in the Central and Eastern European (CEE) region.

Table 1. Average annual growth rates for SEE counties and annual growth rates for 2009 and 2010

<table>
<thead>
<tr>
<th>Period/year</th>
<th>ALB</th>
<th>BIH</th>
<th>BUL</th>
<th>CRO</th>
<th>FYROM</th>
<th>MNE</th>
<th>ROM</th>
<th>SER</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990-2000</td>
<td>-0.6%</td>
<td>n.a.</td>
<td>-3.8%</td>
<td>n.a</td>
<td>n.a</td>
<td>n.a</td>
<td>-2.8%</td>
<td>n.a</td>
</tr>
<tr>
<td>2001-2010</td>
<td>5.5%</td>
<td>3.7%</td>
<td>4.2%</td>
<td>2.8%</td>
<td>2.3%</td>
<td>3.5%</td>
<td>4.2%</td>
<td>4.2%</td>
</tr>
<tr>
<td>2009</td>
<td>3.3%</td>
<td>-3.1%</td>
<td>-5.5%</td>
<td>-5.8%</td>
<td>-0.9%</td>
<td>-5.7%</td>
<td>-7.1%</td>
<td>-3.1%</td>
</tr>
<tr>
<td>2010</td>
<td>3.5%</td>
<td>0.8%</td>
<td>0.1%</td>
<td>-1.4%</td>
<td>0.7%</td>
<td>1.1%</td>
<td>-1.3%</td>
<td>1.7%</td>
</tr>
</tbody>
</table>

Source: IMF World Economic Outlook database, September 2011.

In the first decade of the transition, SEE countries recorded mainly negative average annual growth rates. Growth at that time was affected by the transition recession, by postponed major institutional reforms, by substantial political instability, and by years of war in the region. With political stabilisation, the end of the wars and the speeding-up of institutional reform, growth returned to the SEE region. Nonetheless, in the last 10 years, only one country (Albania) recorded annual average growth rates above five per cent.

Taking into account that SEE countries substantially lag behind the EU15 countries in income per capita, it could be expected that the convergence mechanism would work, i.e., that the growth rates of the poor countries of SEE should be substantially higher than those of the wealthier countries of EU15. Although the growth rates have been higher, on average, in the last 10 years, the difference is not spectacular: only a modest convergence has been achieved. Furthermore, growth in SEE proved to be unsustainable. All SEE countries (except Albania) recorded negative growth rates in 2009, with only mild recovery in some cases in 2010 and further negative growth in Croatia and Romania. This setback is clearly related to the sustainability of the pattern of growth in the region, rather than to a cyclical downswing. Accordingly, although there was some growth in SEE, it has been very far from being a success story. Simple growth accounting can shed more light on the growth process.
Growth accounting in SEE

According to a recent estimate (Borys et al., 2008), the growth of SEE countries in the last half-decade (over the period 2002-2006) has been primarily based on an increase of total factor productivity (TFP) – significantly more than accumulation of physical capital, and much more than accumulation of labour (human capital). In the case of Western Balkans countries, for example, the contribution of TFP over the same period was 87.3%, the contribution of the accumulation of physical capital was 30.6%, while the contribution of accumulation of labour (human capital) was negative (-17.8%).

The substantial increase of TFP can be attributed to the one-off removal of the major inefficiency inherited from the socialist institutional framework – the major reallocation of resources from less efficient to more efficient business endeavours – as the transition gains momentum in SEE, a decade later when compared to that of CEE. Nonetheless, it is reasonable to assume that the recorded increase of TFP is not sustainable. The contribution of TFP increase to growth in the 2004 EU accession countries (CEE countries) in the period of 2002-2006 dropped to 58.1%, compared to 77.3% in the previous (1997-2001) period (Borys et al., 2008).

Evidently, the TFP improvement in both CEE and SEE countries is a one-off event and is not sustainable. Since the major inefficiencies have already been removed, TFP growth now must be based on removing more sophisticated inefficiencies, with decreasing returns of institutional and structural reforms, and on technological progress (innovation), including the capital to labour ratio. Even if success is achieved in these two areas, it is realistic to expect that TFP growth will slow down in the years to come. Accordingly, if TFP improvement is the main source of growth in SEE countries in the future, growth will inevitably slow down compared with the pre-crisis dynamics.

The other source of growth has been an increase in physical capital, with its contribution. The relevant question is one of the origins of the accumulation of capital, as gross domestic savings rates in the SEE countries have been recorded at a very low level for years, almost every year since transition. Although there has been no systematic effort to explore the sources of low savings in the SEE, it is convincing that both affordability to save (low income) and incentives to save (shallow financial system, weak institutions and huge uncertainties) contributed to the low savings rate of households.

From a political economy viewpoint, there has been a strong propensity to consume, as economic policies were focused to increase domestic consumption after a decade of hardship, to maximize the political leverage of the incumbent government to be re-elected. These policies enabled increases in wages far above productivity increases, diminishing the prospects of corporate savings. The structure of public expenditures was dominated by public consumption (with transfers – social benefits and public pensions – being the most important segments of it) and with only modest capital expenditures.

5 These finding regarding the TFP contribution are supported by very similar results obtained by Iradinan (2007) and by the World Bank (2008).
This situation reflects the consumption-prone attitude of the government and contributes to the low level of public sector savings. Reflecting the same pattern of prioritizing a catch-up in household living standards, the expansion of the financial sector was heavily slanted towards mortgages for residential construction, financed by external borrowing.

Accordingly, as domestic savings have been low, physical capital accumulation has been based on the transfer of foreign savings via Foreign Direct Investment (FDI), portfolio investments and cross-border borrowing. The SEE countries, similarly to the Baltic republics, experienced a massive net capital inflow in the last decade. That inflow enabled investment rates that would not have been feasible otherwise (Table 2). Domestic savings covered only a fraction of total investments in physical capital (Gross fixed capital formation).

Table 2. Average annual investment rates and gross national savings rates for 2000-2010 for SEE counties and annual growth rates for 2009 and 2010

<table>
<thead>
<tr>
<th>Country</th>
<th>Investments rate</th>
<th>Gross national savings rate</th>
<th>Investments covered by national savings</th>
</tr>
</thead>
<tbody>
<tr>
<td>ALB</td>
<td>28.2%</td>
<td>20.1%</td>
<td>71.3%</td>
</tr>
<tr>
<td>BIH</td>
<td>25.6%</td>
<td>12.6%</td>
<td>49.2%</td>
</tr>
<tr>
<td>BUL</td>
<td>26.9%</td>
<td>15.4%</td>
<td>57.2%</td>
</tr>
<tr>
<td>CRO</td>
<td>26.3%</td>
<td>20.5%</td>
<td>77.9%</td>
</tr>
<tr>
<td>FYROM</td>
<td>n.a.</td>
<td>16.5%</td>
<td>n.a.</td>
</tr>
<tr>
<td>MNE</td>
<td>24.5%</td>
<td>6.9%</td>
<td>28.2%</td>
</tr>
<tr>
<td>ROM</td>
<td>25.6%</td>
<td>17.9%</td>
<td>69.9%</td>
</tr>
<tr>
<td>SER</td>
<td>22.3%</td>
<td>12.4%</td>
<td>55.6%</td>
</tr>
</tbody>
</table>

Source: IMF World Economic outlook database, September 2011.

The need for foreign savings (transferred via foreign investments and cross-border borrowing) would be even more evident if the data on gross domestic savings were used (these are not available on a comparable basis for all SEE countries), as gross national savings are substantially higher in the SEE countries due to ample remittances.

The contribution of labour (human capital) to growth in the SEE countries has been negative – labour as a production factor is underutilized in the region. The origin of this result can be traced to low flexibility of the labour market, with a substantial mismatch of demand and supply, and a rather low level of human capital. Although some indicators of schooling (e.g., the percentage of people between the ages of 20 and 24 who completed at least secondary education) are not bad compared with EU 15 countries, it is evident that the quality of schooling is rather low (measured by the PISA score) and vocational training opportunities are restricted.

Finally, this model of growth has been led by domestic consumption, with most of the investment, including a substantial part of FDI, focused on non-tradables. The current account deficits created in that way were balanced by huge net capital inflows, something that is not likely to be sustainable. Not only were the achieved growth rates rather modest (taking into account low levels of income per capita), the sources of growth in SEE are not durable (because a
main contribution [TFP growth] is not sustainable in years to come), and the import of foreign savings is expected to be reduced (particularly borrowing), decreasing the possibilities for capital accumulation. The model itself should be changed in order for growth to be preserved and fostered.

**Productivity level and its sources**

Although some real convergence has been accomplished in the last decade, income *per capita* in the SEE countries is still far behind the levels of the EU15. This is not surprising taking into account the gap that exists in levels of productivity (Table 3).

<table>
<thead>
<tr>
<th></th>
<th>ALB</th>
<th>BIH</th>
<th>BUL</th>
<th>CRO</th>
<th>FYROM</th>
<th>MNE</th>
<th>ROM</th>
<th>SER</th>
</tr>
</thead>
<tbody>
<tr>
<td>Productivity</td>
<td>20,2%</td>
<td>18,6%</td>
<td>32,5%</td>
<td>49,7%</td>
<td>24,3%</td>
<td>23,9%</td>
<td>30,9%</td>
<td>29,1%</td>
</tr>
</tbody>
</table>

Table 3. Productivity: PPP Converted GDP Laspeyres per worker at 2005 constant prices as percentage of the EU15 average in 2008

A possible explanation of the productivity gap can be sought in the character of incentives that exist in the SEE countries. Incentives are created by economic institutions, considered in the wide context as rules of the game or ‘human made constraints to the interactions of economic agents’ (North, 1981).

The crucial problem regarding economic institutions in SEE concerns the incentives they create for the allocation of entrepreneurship and innovation. As suggested by Baumol (1990), entrepreneurship can be allocated to alternative activities: productive, distributive and destructive. The latter two basically consist of various forms of legitimate or illegitimate rent-seeking activities that contribute to neither the GDP nor to economic growth. A theoretical model (Murphy *et al.*, 1993) suggested that there are at least two equilibriums, with a good equilibrium (dominant engagement of entrepreneurship and other resources in productive, i.e., growth enhancing activities); and a bad one (with substantial reallocation of resources from productive to rent-seeking activities). The allocation of entrepreneurship, innovation as well as production factors in general, to the three alternative activities depends on relative expected returns. The better the economic institutions, the more protection of private property and contractual rights, the more economic freedom and less compulsory redistribution, the higher relative expected returns in the productive activities, hence the more resources are allocated to these activities, the better the overall allocation of resources and the higher the growth rate. Accordingly, efficient economic institutions minimize rent-seeking activities.

In the SEE countries, the structure of incentives appears wrong from the point of view of economic efficiency, and economic agents behave according to them. Inefficient economic institutions, and the wrong incentives they
create for economic agents, established predominantly rent-seeking societies in the SEE countries.\textsuperscript{6}

While this perception about economic incentives is widely shared among commentators on the region, there is no direct measure of such incentives. We are therefore obliged to find proxies that can help identify the nature of the problem and can also, perhaps, suggest policy routes to addressing it.

An indirect way of identifying a relative allocation of resources in productive and rent-seeking activities is by measuring the quality of the business environment, including the level of economic freedom and the quality of governance. Using the available data from the major international projects focused on these measurements (Table 4 – see also Chapter 2), it is evident that SEE countries are endowed with a poor business environment, and that they are lagging significantly behind the EU15 countries based on their unweighted average value, or median rank.

Table 4. Quality of the business environment by various indicators: SEE countries and EU15 countries

<table>
<thead>
<tr>
<th>Indicator</th>
<th>ALB</th>
<th>BIH</th>
<th>BUL</th>
<th>CRO</th>
<th>FYROM</th>
<th>MNE</th>
<th>ROM</th>
<th>SER</th>
<th>EU 15</th>
</tr>
</thead>
<tbody>
<tr>
<td>Doing Business 2008 rank</td>
<td>82</td>
<td>116</td>
<td>44</td>
<td>103</td>
<td>32</td>
<td>71</td>
<td>55</td>
<td>88</td>
<td>28</td>
</tr>
<tr>
<td>Heritage/WSJ Economic freedom Index score 2008</td>
<td>66.0</td>
<td>56.2</td>
<td>62.3</td>
<td>59.2</td>
<td>65.7</td>
<td>63.6</td>
<td>64.2</td>
<td>56.9</td>
<td>71.4</td>
</tr>
<tr>
<td>WEF competitiveness rank 2008</td>
<td>96</td>
<td>109</td>
<td>76</td>
<td>72</td>
<td>84</td>
<td>62</td>
<td>63</td>
<td>93</td>
<td>17</td>
</tr>
</tbody>
</table>

Source: World Bank, Heritage Foundation and World Economic Forum. Data for 2008 are used to avoid distortions that can be expected from the short-term government reaction to the 2008 financial crises and subsequent recession.

Obviously, the low quality of the business environment demonstrated a lack of proper institutional reforms, those of the economic institutions that create an efficient business environment, the ones that enable dynamic economic growth. Together with a very low level of economic freedom (EU15 countries are definitely not the champions of economic freedom) these findings corroborate the hypothesis that the SEE countries are rent-seeking societies. The quality of the governance data (Table 5 – the higher the score, the higher the quality of governance) does not contradict this finding.

\textsuperscript{6} The adjective “inefficient” refers to the outcome of these economic institutions, i.e., the inefficient allocation of resources. That does not mean that the institutions themselves are not effective. On the contrary, exactly because they are effective, their outcome is inefficient.
Chapter 1. The political economy context of economic growth in South East Europe

Table 5. Composite governance indicators for SEE countries and the EU-15 member states in 2008

<table>
<thead>
<tr>
<th>Governance Indicator</th>
<th>ALB</th>
<th>BIH</th>
<th>BUL</th>
<th>CRO</th>
<th>FYROM</th>
<th>MNE</th>
<th>ROM</th>
<th>SER</th>
<th>EU 15</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accountability</td>
<td>51.4</td>
<td>48.5</td>
<td>65.8</td>
<td>60.0</td>
<td>53.3</td>
<td>56.2</td>
<td>59.1</td>
<td>54.8</td>
<td>93.7</td>
</tr>
<tr>
<td>Political stability</td>
<td>45.4</td>
<td>25.8</td>
<td>58.8</td>
<td>66.5</td>
<td>33.9</td>
<td>68.8</td>
<td>55.9</td>
<td>28.2</td>
<td>82.2</td>
</tr>
<tr>
<td>Government effectiveness</td>
<td>44.5</td>
<td>35.0</td>
<td>58.2</td>
<td>69.6</td>
<td>50.7</td>
<td>56.8</td>
<td>50.2</td>
<td>47.8</td>
<td>92.4</td>
</tr>
<tr>
<td>Regulatory quality</td>
<td>57.0</td>
<td>48.7</td>
<td>73.4</td>
<td>66.6</td>
<td>58.4</td>
<td>52.1</td>
<td>67.6</td>
<td>47.3</td>
<td>93.7</td>
</tr>
<tr>
<td>Rule of law</td>
<td>32.5</td>
<td>43.5</td>
<td>51.1</td>
<td>55.0</td>
<td>45.4</td>
<td>53.1</td>
<td>53.5</td>
<td>41.1</td>
<td>93.3</td>
</tr>
<tr>
<td>Control of corruption</td>
<td>39.1</td>
<td>45.8</td>
<td>52.1</td>
<td>61.8</td>
<td>54.5</td>
<td>47.8</td>
<td>57.0</td>
<td>53.1</td>
<td>92.7</td>
</tr>
</tbody>
</table>

Source: The World Bank Institute, Worldwide Governance Indicators online database.

The low quality of governance, particularly the rule of law and control of corruption (the biggest average gap exists between the EU 15 countries and countries in SEE in terms of these two indicators) demonstrates the extent to which the countries of this region are far from being fully-fledged market economies with limited incentives for rent seeking.

A further indirect corroboration of the rent-seeking character of societies in SEE is the very low level of activity of the population. Here, two factors are at play, both related to inefficiency in the economy. The first is “unwilling unemployment”, which is the consequence of low flexibility in the labour market, mismatches on this market and inadequate vocational training capacity. The second is related to rent-seeking: many people withdraw from the labour market, at least the formal one, and survive on transfers of various kinds (unemployment payments, early retirement pensions, etc.) provided by the state. Notably, the participation rate in SEE countries is lower than that of the EU15, on average (Table 6). This low participation rate can be explained, among other things, by widespread social benefits (not necessarily targeting the poor or vulnerable), low retirement ages, extensive practices of early retirement, and a substantial grey economy compared with the EU15 countries.

Table 6. Labour force: Unemployment, employment and participation rates for 2006

<table>
<thead>
<tr>
<th>ALB</th>
<th>BIH</th>
<th>BUL</th>
<th>CRO</th>
<th>FYROM</th>
<th>MNE</th>
<th>ROM</th>
<th>SER</th>
<th>EU 15</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unemployment rate</td>
<td>14.0%</td>
<td>41.0%</td>
<td>n.a.</td>
<td>12.0%</td>
<td>36.0%</td>
<td>30.3%</td>
<td>n.a.</td>
<td>21.6%</td>
</tr>
<tr>
<td>Employment rate</td>
<td>49.7%</td>
<td>29.7%</td>
<td>n.a.</td>
<td>55.0%</td>
<td>34.1%</td>
<td>34.8%</td>
<td>n.a.</td>
<td>51.0%</td>
</tr>
<tr>
<td>Participation rate</td>
<td>65.1%</td>
<td>74.4%</td>
<td>65.0%</td>
<td>64.2%</td>
<td>60.6%</td>
<td>49.4%</td>
<td>63.1%</td>
<td>63.6%</td>
</tr>
</tbody>
</table>

Source: Borys et al. (2008) and the World Bank online database.

It is empirically clear that economic institutions in SEE countries are inefficient, and a crucial question concerns the origin of these institutions. Although there is no theoretical consensus concerning the origin of economic institutions (for a debate see: Acemoglu et al., 2005), it is reasonable to accept the proposition that most of the economic institutions are designed, reformed and enforced
in a political process, through a “top to bottom” approach. In effect, political institutions dominate economic institutions; and the reasons for a specific design of economic institutions, or the lack of their reform, are to be found in the political sphere. If this proposition is accepted, than all the obstacles to the reform of economic institutions are effectively political.

Nevertheless, one should be aware that the origin of economic institutions is a rather complex issue and that economic institutions are not only dealt with via a political process. Without going deeply into examining the legal origin theory of economic institutions and assessing its analytical values,7 some empirical research demonstrates that economic institutions in the SEE were partially influenced by the legal origin, by the region’s history.8 Some of the economic institutions belong to the class of deep and persistent institutions: they could frequently be informal, but very effective. These institutions have substantial inertia and are rather resistant to the outcomes of political process, to collective decisions concerning institutional reform.

Taking all that into account, that does not mean that political institutions and political processes do not have a decisive role in institutional reform. Countries and nations are not hostages of history, though history no doubt influences the starting point and path of institutional reform – path dependence is a widespread phenomenon. Otherwise, a massive and successful institutional reform in CEE countries during their transition (including the countries that were a part of the Soviet Union, like the Baltic republics) would not have been possible.

There is no doubt, in other words, that incumbent economic institutions can be reformed and new economic institutions can be built. A prerequisite for such a development is a political decision. Accordingly, the crucial question is: what are the political obstacles for such an institutional reform in SEE countries?

Political obstacles for institutional reform

As already pointed out, the major obstacles to rapid institutional reform in SEE countries lie in the political sphere. One of these obstacles has been based on the fact that constitutional and national security issues have been dominating countries’ political agenda. SEE is inherently a non-stable region, as stability in the past has been imposed by the empires: the Ottoman, Hapsburg and even communist empires (the Soviet empire and the structures of former Yugoslavia). The latest bout of instability in the region, caused by the wars

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7 Seminal contribution in the area of theory of legal origin as a theory of institutional design and effectively an institutional theory of economic growth is: La Porta et al. (1998). The overview of the theory and responses to the theory critics can be found in: La Porta et al. (2008).

8 For example, Grosjean (2011) found that the Ottoman occupation and Ottoman legal/financial system and its Islamic component left some traces in informal financial institutions in the SEE, although the contemporary banking system in those countries is almost completely owned by foreign (Eurozone) banks and the banking legislation is consistent with the legislation in the EU.
for Yugoslav succession in the 1990s, created a precarious atmosphere riddled with constitutional and national security issues. Within this context, projects of nation-building and institutional deepening were initiated, but in the majority of cases remain works-in-progress with rather uncertain results.

Such a constellation drains substantial resources and political energy to resolve these existential issues of the state. In this setting, the reform of domestic economic institutions has not been the top priority for most of the last 20 years. Resources allocated to these issues bear their own opportunity costs. Furthermore, the dominance of such issues on the political agenda tends to increase political instability. It has been demonstrated that, for given economic institutions, such instability decreases economic growth (Alesina et al., 1996).

An interesting case supporting this view is that of Slovenia. Obviously, Slovenia managed to sort out its constitutional and national security issues very early in the transition process (the border dispute with Croatia has never been a major issue in this regard), and completely focused on matters of economic transition. None of the countries of the Western Balkans has had such an opportunity. Although Romania and Bulgaria did not encounter significant constitutional problems, their national security trade patterns were affected by wars in former Yugoslavia, while the legacy of transition included major domestic problems of corruption and organized crime. Slovenia’s relative freedom from such issues, as well as its close links with adjacent EU economies, clearly allowed a more systematic and sustained policy focus on institutional reform.

It has been suggested (Landesmann, 2010) that the EU perspective — candidate or potential candidate status — triggers a convergence mechanism and speeds-up growth in SEE countries. The crucial mechanism is nonetheless an indirect one. The economic convergence mechanism — in the sense of a catching-up of living standards — is in fact triggered by institutional convergence, enabling the activation of a “club” convergence mechanism. In that sense, the EU accession aspirations of SEE countries can be considered as a driver of the reform of economic institutions.

Basically, this is a kind of surrogate incentive. Instead of the political process providing a political decision and plan for the reform of economic institutions, the political process provided a decision for EU accession, and the accession process, through its conditionality, provided the incentives for the reform of economic institutions. Accordingly, the EU accession process is the main driver of institutional reforms, i.e., the reform of economic institutions to make them compatible with the institutions of the EU member states, generally considered to be beneficial to economic growth.

The problem with this mechanism, however, is that no credible signals exist that the EU is committed to enlargement in the Western Balkans after Croatia. The last signal for the Western Balkans countries came in 2003 (Thessaloniki

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9 For other possible explanations of Slovenia’s relative success, see Gligorov (2011).
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with the message that there is “a European perspective for the Western Balkan nations”, but there has been no new strong message and/or credible signal since, even with recent granting of candidate status to Montenegro and Serbia. On the contrary, FYR of Macedonia, for example, has still not managed to start accession negotiations as of mid-2012, seven years after attaining candidate status. Candidate status is awarded to Montenegro and Serbia, though without a date for stating negotiations, as all other countries are still in limbo, with potential candidate status, without any commitment from the EU.

The informal signals that are coming from Brussels are that no new “Bulgaria and Romania” will be allowed, referring to the quality of governance yardstick, and that no new “Cyprus” will be allowed, referring to the issue of borders. The problem, however, rests in the fact that virtually all candidates and potential candidates for EU membership in the Western Balkans are cases of problematic governance and borders. In that framework, the signals sent from Brussels are read as meaning that there is no enlargement in the foreseeable future, as enlargement fatigue dominates the enlargement section of the agenda in Brussels. Furthermore, the enlargement section of the agenda itself is shrinking, yielding room to fundamental questions of the future of the monetary union, the EU itself, and its character, basics of the decision-making process, etc. It is evident that enlargement is not a priority at the moment, and it is reasonable to expect that it will not be one in the near future. For SEE countries, EU membership has become more or less a moving target.

Since EU accession – for SEE countries that are not yet members (excluding Croatia, which already signed the accession document) – has entered a sort of “Waiting for Godot” holding pattern, the strength of the related conditionality incentives has diminished substantially. The reform of economic institutions, which was driven externally, must now be driven internally. It is not evident that domestic political elites in SEE countries have both the motives and the strength to switch to the new situation and to put in place a domestically driven reform of economic institutions. The issue is whether domestic political elites can be credible and effective in performing this new role.

Another political obstacle to the thorough reform of political institutions in the countries of former Yugoslavia could be a still rather widespread illusion that the self management version of socialism was essentially a market-based economic system – and that problems of economic incentives are therefore less systemic and less problematic than where central planning was deeply embedded. Nonetheless, the weak performance of the economy, and comparative measures of the business environment, confirm beyond doubt

10 The decision about Serbia’s date of accession negotiations is to take place in December 2012.

11 The point that all the candidates and potential candidates are up to a point new “Cypruses” has been made during the Conference “Balkans 2012” that took place at the LSE in London on 27 January 2012 under Chatham House rule.
that there is need for thorough institutional reform. Years of hardship during the decade of the civil wars reinforced nostalgia among the population for the time of socialism, when the quality of life for many was better than in the first decade following it. Nonetheless, as time passes, this obstacle has diminished as the romanticised memories of the past system faded out, irrespectively of the nostalgia for the past.

Furthermore, political support for the reform of economic institutions is about credible commitment and compensation of the “losers”. These reforms do not result in a Pareto improvement; instead, there are winners and losers. The process occurs in conditions of uncertainty, as individuals cannot be sure \textit{ex ante} about the outcome. Hence, they can only expect to emerge as winners and losers, with some probability of the outcome. Taking all that into account, as pointed out by Fernandez and Rodrik (1991), even the winner may vote against economic reform, since the losers of the reform cannot be identified \textit{ex ante}. This mechanism leads to \textit{ex ante} political obstacles, as political parties will not garner enough political support for reform implementation (potential losers will vote against pro-reform political actors). The logical way out of this situation would be to implement a robust mechanism to compensate most of the losers of the reform. The problem lies in time consistency, because politicians cannot commit to the compensation scheme \textit{ex ante}, i.e., before they are elected. Furthermore, in many cases, such a commitment is not credible either \textit{ex ante} or \textit{ex post}, as there is no fiscal or/and administrative capacity for such widespread compensation, at least in the short-term.

The other political obstacle to institutional reform lies in basically \textit{ex post} obstacles: the losers will vote out the reform government, and vote for political parties they hope will stop, reverse or annul the reform of economic institutions. Although there are theoretical models (Wyplosz, 1993) that project that \textit{ex post} political obstacles are stronger then \textit{ex ante} obstacles, meaning that it is politically more difficult to maintain institutional reforms than to initiate them, there has been only scattered empirical evidence on this regularity (Begović and Paunovic, 2011).

The concept of reform/transition losers is predominantly associated with losing the job (in state owned firms or in the public sector). Accordingly, the issues of political obstacles (both \textit{ex ante} and \textit{ex post}, irrespectively of their strength) can be theoretically summarized by the concept of optimal pace of

\textsuperscript{12} A completely different setup existed at the beginning of transition in the CEE, as there were no illusions about the character of the economic system brought to these countries by the Soviet occupation. Furthermore, reform of economic institutions was essential segment of the big political projects of leaving Soviet “empire” for good and becoming a part of the western world.

\textsuperscript{13} Golineli and Rovelli (2012) report that cross-country differences in the extent of nostalgia towards the past are mainly related to differences in the deterioration of standard of living. This finding is based on the econometric research on the sample of 14 transitional countries. It sheds additional light to the “self-management” illusion diminishing relevance.

\textsuperscript{14} Taking into account a fiscal strain that is produced by the need for a widespread compensation that increases with the speed of transition, a proposition for the desirability of the slower pace of transition (Dewatripont and Roland, 1992) and even partial reforms of the economic institutions (Dewatripont and Roland, 1995) has been suggested.
job losses (Aghion and Blanchard, 1994). Too many job losses in the state/public sector, not matched with job creation in the private sector, create high unemployment (losers who lost their jobs) that creates both ex ante and ex post political barriers to institutional reform.15

Although there has been a conjecture that the unemployed support anti-reform political parties, hoping to preserve or even reintroduce transfers in their favour and thus creating a political obstacle to institutional reform, Rodrik (1995) indicated that the unemployed know very well that the only sustainable employment is in the private sector, and therefore they support institutional reform in order to create conditions for the fastest possible advancement of the private sector and the creation of as many jobs as possible, increasing chances for their new and sustainable employment. In principle, they should thus support a reform process that creates a more healthy and dynamic business environment, even if it reduces untargeted transfers. The problem with this conjecture is that it is based on the assumption that there is no labour market mismatch, i.e., that the demand for labour by the private sector is perfectly matched to the supply of the labour by the unemployed who lost their jobs in the public sector. Not only is this not the case, but the losers (the unemployed) are aware that the demand for labour from the private sector does not fit their skills and working habits. Accordingly, they will support anti-reform political parties hoping that these parties will provide them compensation – income redistribution through transfers to those who lost their jobs (unemployment benefits, extended period of unemployment insurance, early retirement, etc.) – preferable to the level that enables them to stop looking for a new job.

Empirical research (Fidrmuc, 2000; Warner, 2001; Valev, 2004; and Kim and Pirttila, 2004) in the CEE and SEE provided some evidence that unemployment can be a ground for political obstacles to institutional reform. Other empirical research, however, (Jackson et al., 2003, Begović and Paunović, 2011, and Rovelli and Zajceva, 2011) demonstrated that the link between reduced political support for reforms and unemployment is weak, not robust, and in many cases not statistically significant. Yet other explanatory variables, predominantly demographic ones, were highly statistically significant. Senior citizens, those with lower human capital and refugees (in SEE) proved to be against institutional reforms. It seems, though, that there is no direct empirical confirmation that these segments of the population have substantially higher risk aversion than others.16

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15 On the other hand, keeping jobs in the public sector, i.e. to little unemployment undermines development of the private sector, primarily due to the distortions at the labour market. Too high equilibrium wages, due to the implicit and explicit subsidies, create crucial obstacles for the economic growth based on the private sector investments. Accordingly, optimal level of unemployment is the one that minimizes both harms to the transition and economic growth (Aghion and Blanchard, 1994).

16 There is no sufficient ground to assume that risk attitudes systematically differ among the nations apart from the difference in demographic structure – there is no evidence that one culture is more risk than another, at least not in the cases of transition countries.
To the extent that the hypothesis that the unemployed create political obstacles to reform can be accepted, levels of unemployment (Table 6) can be considered as an indicator of the lack of political support for the reform of economic institutions.\textsuperscript{17} If that hypothesis is valid, than a specific “unemployment trap” could be detected. The high level of unemployment creates a political barrier to institutional reform, and because there is no reform of economic institutions, there are no incentives for investment that will create economic growth and generate new jobs. As such, the unemployment rate will remain high and even become higher.

Taking all that into account, it is reasonable to assume that the SEE countries were not able to secure compensation for the transition losers, at least a credible commitment to such compensation, to the extent it was secured in the CEE countries. Accordingly, political support for institutional reforms has not been as robust in the SEE countries as it has been in the CEE countries. That does not mean, however, that there is no compulsory income distribution (both explicit and implicit) in the SEE countries. The problem, however, is that only a part of it flows to the transition losers. A substantial part of distributed income flows to the new political and economic elite, the one that surfaced in the 1990s, when societies in the SEE countries were turned upside down. Societies in the SEE countries are to a great extent captured societies in which the interests of the elites are articulated as the public interest of the societies.

Vested interests proved to be the other political obstacle to the reform of economic institutions, as there is not a fully developed democratic political institutional framework that can facilitate institutional reform by bringing different stakeholders to the public debate about institutional reform, and in which all of them can articulate and express their own interest. Obviously, some stakeholders are excluded from the public debate and do not have an opportunity to articulate and express their own interests. This is typical for small entrepreneurs, both those who run Small and Medium-sized Enterprises (SMEs) and generate some additional employment, and self-employed entrepreneurs. Societies of SEE countries are still limited access societies (North et al., 2009).

This hypothesis can be supported using the EIU democracy index score for SEE countries compared to that of the EU 15 countries as a benchmark for solid, well established democracies, i.e., ‘open access societies’ (Table 7).

\textsuperscript{17} Though it is convincing that the unemployed, because they lost jobs in the public sector, are against institutional reform, it is not so convincing in the case of young people who were never employed. Accordingly, data on unemployment should be interpreted together with data on unemployment of young people to get a correct picture of unemployment as a political barrier to the reform of economic institutions.
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Table 7. Democracy index score: SEE countries and the EU-15 member states

<table>
<thead>
<tr>
<th>Democracy score</th>
<th>ALB</th>
<th>BIH</th>
<th>BUL</th>
<th>CRO</th>
<th>FYROM</th>
<th>MNE</th>
<th>ROM</th>
<th>SER</th>
<th>EU 15</th>
</tr>
</thead>
<tbody>
<tr>
<td>EIU Democracy Index score 2008</td>
<td>5.91</td>
<td>5.70</td>
<td>7.02</td>
<td>7.04</td>
<td>6.21</td>
<td>6.43</td>
<td>7.06</td>
<td>6.49</td>
<td>8.61</td>
</tr>
<tr>
<td>EIU Democracy Index score 2010</td>
<td>5.86</td>
<td>5.32</td>
<td>6.84</td>
<td>6.81</td>
<td>6.16</td>
<td>6.27</td>
<td>6.60</td>
<td>6.33</td>
<td>8.45</td>
</tr>
<tr>
<td>EIU Democracy Index score 2011</td>
<td>5.81</td>
<td>5.24</td>
<td>6.78</td>
<td>6.73</td>
<td>6.16</td>
<td>6.15</td>
<td>6.54</td>
<td>6.33</td>
<td>8.40</td>
</tr>
</tbody>
</table>

Sources: Economic Intelligence Unit, Democracy Index Reports. The maximum score for a country is 10.

The recorded index scores suggest that incumbent political and business elites and their vested interests hold greater sway in the SEE countries than in the EU15. Furthermore, since the scores have deteriorated since the beginning of the 2008 crises, the grip of the elites in SEE countries is stronger in 2011 than it was in previous years. In the short run, elites will lose by turning these societies into open access societies, thus creating obstacles to the reform of political institutions and democratization.

Although relations between democracy and economic growth are complex, it is reasonable to assume that the beneficial effects of democracy are greater with increasing levels of per capita income, and countries of SEE lag behind in terms of economic development. 18 Furthermore, it was demonstrated (Fidrmuc, 2003) that in transition countries political and economic liberalization reinforced one other with beneficial effects on growth.

It is reasonable to expect that incumbent political and business elites will support both political and economic institutional reforms only if they believe that the existing privileges are not sustainable. In that case, institutional reform will be driven from the inside. The question is whether the second wave of the crisis will trigger such a development.

The second wave of the crisis: Some beneficial side effects?

Taking identified political obstacles to the reform of economic institutions, the second wave of the crisis, triggered in 2011 as the sovereign debt crisis in the Euro Zone, could be an opportunity for radical change of the political constellation in SEE countries, creating incentives for the reform of economic institutions. It is evident that the easy solutions are over and that the manoeuvring space for the SEE countries in terms of short-term economic policy reactions is extremely limited. What is needed is a completely new growth model that can be achieved only through a thorough reform of economic institutions. Hence, the question is what would be political incentives for such a shift in the behaviour of political and business elites of SEE countries.

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18 Aghion et al. (2007) provided a theoretical explanation of the mechanism by which higher levels of economic development (shorter distance to the technological frontier) increases the relevance of democracy for economic growth. Some empirical evidence to support this hypothesis is also provided.
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The very fact that the incumbent growth model is not sustainable is slowly becoming “conventional wisdom”, even among the elites of SEE countries. That means that their rents and their tax base are not sustainable and that some of the current inflows must be sacrificed for future sustainable flows. That reasoning follows the argument that the biggest institutional reforms were accomplished only out of dire necessity (Lal, 2006).

It is important to conceive what will be the economic framework within which the process of political decisions would take place. It is evident, first of all, that borrowing as a vehicle for net capital inflows to SEE countries will be much more scarce than in the last period, even in the first post-crisis (2008) years. Huge pressure on the parent banks in the Euro Zone countries, both pressure from the capital markets and domestic regulators, will inevitably lead to deleveraging. A net outflow of loans has already been recorded in the second half of 2011, and early introduction of the Basel 3 regulations of capital requirements, together with dire prospects for capital increase, means that more net outflow of capital can be expected while less will be available for new borrowing.

The second important element of the growth puzzle is that the TFP growth that was recorded in the last decade is not sustainable – major inefficiencies have been removed and the removal of remaining inefficiencies is more difficult and produces diminishing returns. Thus, the sources of growth must be technological progress (to keep TFP from drastic downfall) and increases of both physical and human capital.

The third element is the future dynamics of the domestic savings rate. Until now, savings rates were not sufficient for investment rates, even with the modest contribution of physical capital increase to economic growth. With reduced borrowing possibilities, the crucial question is whether gross domestic savings can increase to compensate for the gap that will inevitably be created. As to the ability to save, as recession in the SEE countries is not ruled out, the propensity to save can decrease along with income. As to the incentives to save, there could be movement in different directions. It has been pointed out (Landesmann, 2010) that decreased possibility to borrow and/or worsening conditions of borrowing can provide incentives for households to save more as the only way to purchase durable goods. On the other hand, incentives in terms of building appropriate financial institutions cannot be accomplished in the short run, and good financial institutions need time to be built. Increasing consumption has been paramount for election success in SEE, driving consumption to high levels, with limited public savings, i.e., capital expenditures. Furthermore, politically preferred high wages will keep corporate savings down.

It seems, on balance, that FDI will be the most resilient source of physical capital investments in SEE countries. The beneficial effects of FDI are not restricted to the accumulation of physical capital. On the one hand, FDI are a reliable channel for technology transfer, i.e., for the transfer of technological progress that is crucial for sustainable growth of the TFP. On the other hand,
that technological progress is not restricted to the recipient firm as there are substantial spill over effects, both intra-industry or inter-industry.

Nonetheless, the crucial prerequisite for attracting FDI is an improvement in the business environment, achieved through thorough institutional reform, more radical than anything seen in the SEE countries until now. Furthermore, for the full potential of spill over effects to materialize, the absorbing capacity of the SEE countries must be improved through improvements in human capital. These improvements can be achieved only through institutional and structural reforms of the education system and research and development system, as both are very inefficient in SEE countries at the moment.

Such institutional reform could establish a virtuous circle. Initial reforms provide incentives for more FDIs and for increased spill over effects, and these developments accelerate economic growth, increasing income and tax bases, and showing that such reforms are beneficial to the general public. Such political/economic success could provide incentives for more reform and institutional convergence to the EU15 countries. The issue is, nonetheless, the time horizon of such institutional reforms. Usually, there are short-term political costs as well as long-term political benefits. Accordingly, the beginning of a government’s mandate should be a suitable time for such reforms.

The challenge is also linked to the structure of FDI. The majority of FDI, until now, has been investment in non-tradable sectors. Most of FDI represented market-driven investment rather than efficiency-driven FDI. The price competitiveness of the countries should be established via appropriate foreign exchange policy, if it is available, and/or appropriate policies that control wage levels and increases. The crucial issue to attract efficient, export-oriented FDI in tradable sectors is to keep unit labour costs competitive in real terms.

Without thorough reform, a vicious circle could arise: no institutional reform, no FDI, low growth and stagnation and disappointment of the general public, further decreasing incentives for institutional reform. The on-going second wave of the crisis could become another lost opportunity.

References


Chapter 2. Making sense of competitiveness indicators in South East Europe

Peter Sanfey and Simone Zeh

Introduction

The transition economies of South East Europe (SEE) have been deeply affected by the global economic crisis and its aftermath. Economic growth in the past few years has been weak or non-existent, unemployment and poverty levels have risen, and investment and confidence have tumbled. The region is also heavily exposed to the Eurozone sovereign debt crisis, which has the potential to spill over into SEE countries in a highly negative way, possibly causing deep damage to the region’s economies. Even under a relatively favourable resolution of the Eurozone’s troubles, growth in SEE is likely to be marginal at best in the short term.

Many of the region’s problems cannot be solved, or even alleviated, unless robust economic growth returns. But the pre-crisis growth model, which was built largely on booming credit growth and huge inflows of cheap capital from abroad, cannot be a suitable basis for future growth, and foreign investment is likely to stay well below levels seen in 2005-08, at least for the foreseeable future. Meanwhile, many foreign-owned banks, which dominate the financial sectors of the region, are trying to reduce their balance sheets – or “deleverage” – to more manageable levels. At the same time, there is very little scope for fiscal or monetary stimulus. So how can sustainable growth be achieved?

The answer could be that authorities across the region must show a much greater commitment than before to deep structural and institutional reforms.

19 The authors are, respectively, Deputy Director of Country Strategy and Policy in the Office of the Chief Economist, and Regional Coordinator for the Western Balkans in the Small Business Support Team, both at the EBRD. We are grateful to Othon Anastasakis, Ralph de Haas, Libor Krkoska, Marija Kuzmanović and Max Watson for their comments and assistance. The views expressed in this paper are those of the authors only and not necessarily of the EBRD.

20 In this paper, “South East Europe” refers to Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia, Montenegro, Romania and Serbia.
It is generally accepted that reforms and growth have gone hand-in-hand in transition economies.\(^{21}\) However, although there has been much talk of the need for a new “growth agenda” since the global crisis unfolded, there is little agreement as to what this agenda should be or which reforms are most important. There is a plethora of cross-country indicators that attempt to measure concepts such as competitiveness, ease of doing business, transition gaps and the like, but the results and relative rankings they generate are often confusing and sometimes appear to be mutually inconsistent. This is a headache for analysts and policy-makers who need to diagnose the problem correctly before they can propose and implement an appropriate solution.

The main aims of this chapter, therefore, are to summarise several well-known competitiveness and business environment measures and to explain what they are trying to capture. To the best of our knowledge, this is the first time that anyone has tried to compare and contrast some of the most prominent cross-country indicators and to point out both the strengths and the weaknesses in one self-contained paper. We also try to draw some policy implications from the analysis. This chapter is not meant to be a reform blueprint for the region, but rather a helpful pointer towards concrete reform measures in areas such as trade, access to credit and cross-border cooperation, topics that are then covered in more depth in subsequent chapters of this volume. An annex provides a handy tabular guide to the indicators – sources, coverage, objectives, strengths and weaknesses.

**Impact of the crisis**

The full extent of the impact of the global crisis on SEE is only now becoming clear.\(^{22}\) At the start of 2011, it seemed that SEE had been no worse hit than most other transition sub-regions. The real GDP drop in 2009 – around 5.5 per cent on a weighted average basis – supported this view. Towards the end of 2010, some tentative signs of recovery started to emerge.\(^{23}\) By early-2012, however, the short-term prospects still looked bleak. Most independent forecasters, and even national authorities, predict minimal growth at best for the region in 2012.\(^{24}\)

Beyond the basic GDP figures, there are at least three facts that help to explain why SEE is struggling so badly.\(^{25}\) The first fact is that the estimates

\(^{21}\) See, for example, Falcetti et al. (2006).

\(^{22}\) Several recent papers analyse the impact of the crisis on SEE, including Bartlett and Prica (2011), Cocozza et al. (2011) and Sanfey (2011).

\(^{23}\) Two edited volumes on the region produced in late-2010/early-2011, one by the London School of Economics and one by Oxford University, capture this nascent sense of optimism with their titles: “South Eastern Europe after the Crisis”, and “From Crisis to Recovery”, respectively. See Bartlett and Monastiriotis, eds. (2010) and Anastasakis, Bastian and Watson, eds. (2011).


\(^{25}\) Other factors behind SEE’s recent malaise include the tight linkages of the region with problematic euro area banking groups and the close trade links to troubled southern European economies.
of growth decline in the crisis do not accurately convey how badly people suffered during it. Evidence from the second round of the EBRD/World Bank Life in Transition survey (LiTS), carried out in late-2010, supports this assertion. In this survey, people were asked how much the crisis has affected their household in the past two years. Chart 1 shows that in all SEE countries a majority of people responded that it affected them a great deal or a fair amount, compared to a transition region average of just over 40 per cent. This finding may also help explain why self-reported life satisfaction in the LiTS is so low in SEE.26

**Chart 1: Impact of the Crisis**

![Impact of the Crisis Chart]


The second fact is that consumer confidence remains well below pre-crisis levels, and has even been falling again in recent months, as shown by evidence from three countries in the region – Bulgaria, Croatia and Romania – where such surveys are carried out regularly according to a standardised Eurostat methodology (see Chart 2). The gap in confidence between these countries on the one side and the EU average on the other widened significantly during the crisis and remains large in Bulgaria and Romania despite a partial recovery in the first half of 2011.

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26 For example, in the 2010 round of the EBRD/World Bank Life in Transition Survey, only 18 per cent of respondents in Romania – the lowest percentage across the whole transition region – declared themselves to be satisfied with life (see EBRD, 2011a).
The third fact is that the region has suffered a major drop in foreign direct investment (FDI), not just in 2009 for the following two years as well. During the pre-crisis period, the region was attracting around 25 billion USD (in net terms) annually, compared to just 12 billion USD in annual flows in 2009-11 (see Chart 3). Only Albania and Montenegro saw any increase between the two periods, and this can be mostly explained by a couple of large privatisations. The steep fall elsewhere is hardly surprising given the sharp drop in investors’ appetite for risk.

Source: Eurostat.
Cross-country indicators

While short-term prospects are gloomy, the medium- to long-term outlook for SEE should be a bright one. The region has plenty of catching-up to do when it is viewed in relation to the main trading partners in Western Europe; GDP per capita (in purchasing power parity terms) is less than half the EU average in all countries except Croatia.27 A basic tenet of standard economic growth theory is that capital should flow from rich to poor countries, enabling the latter to grow faster than the former provided the right conditions are in place for growth to occur. The key proviso is the phrase “right conditions” – what does it mean, and how far behind does the region lag in terms of putting these conditions in place? 

The following pages of this chapter will try to answer these questions, drawing on a range of existing surveys, measurements, subjective judgements and other information. There is a wealth of different, and sometimes contradictory, cross-country indicators at hand. Some of them have a global coverage, and are therefore potentially useful for showing how SEE compares with other regions around the world at a broadly similar stage of economic development, as well as with the rich countries of the OECD. Others are restricted to the transition region, in which case the most suitable comparators for SEE countries are the Central European and Baltic states (CEB).

How competitive is South East Europe? Our starting point for answering this difficult question is the World Economic Forum’s comprehensive annual indicator – the Global Competitiveness Index (GCI) – that is currently compiled for 142 countries. Based on an assessment of various weighted indicators along 12 pillars, it measures the fundamentals required for a competitive environment, such as the institutional framework, quality of infrastructure and macroeconomic stability. It further looks at efficiency-enhancing indicators, primarily education and labour market policies, as well as innovation factors. The indicators are built upon both hard data and the results of an executive opinion survey, which combines the perceptions of executive managers (a median of 89 in each country) on issues related to public institutions, corruption, infrastructure and the environment.28

Chart 4 shows the relative ranking of each SEE country, on a scale of 1 (lowest) to 7 (highest). Perhaps surprisingly, there appears to be little variation within the region. On this measure, Montenegro is the most competitive country in SEE, with a score of 4.3, followed by Bulgaria (4.2), and then Albania, Croatia, FYR Macedonia and Romania (all at 4.1). Serbia and Bosnia and Herzegovina lag behind at 3.9 and 3.8, respectively. The average (unweighted) score of the region is 4.05, compared to the OECD average of 5.0.


28 For further information on the methodology of the WEF Global Competitiveness Index, see http://www3.weforum.org/docs/WEF_GCR_Report_2011-12.pdf.
The fact that the overall scores do not vary much within SEE is an interesting finding. A closer examination of the components of this index reveals a number of similarities across the region, and points to a general problem that SEE countries are facing. According to the CGI’s analysis, all countries score particularly poorly with regard to innovation and sophistication factors, with a regional average of only 3.2, whilst conversely, they perform comparably well with regard to fundamental macroeconomic requirements.

It is questionable, however, how much value can be attributed to this broad index, especially the part relating to the executive scores, as the sample size for most countries is quite small. The GCI is a useful starting point that provides “the big picture” but has limited value for policymakers who wish to diagnose the problems and propose solutions. In order to make better use of the large variety of surveys available, and to get a closer picture of the strengths and weaknesses of the economies of South East Europe, this paper will explore some key elements of competitiveness, such as the overall business environment, trade, infrastructure, human capital development and the institutional framework.

**Business environment and corruption**

Some observers claim that a major source of SEE’s economic problems lies in the difficulties private companies face in operating enterprises. There are two main approaches to measuring the quality of the business environment. One approach looks at objective indicators associated with starting up a business and trading, both internally and across borders. This involves measurement of such factors as the length of time it takes to establish a company, the number
Chapter 2. Making sense of competitiveness indicators in South East Europe

of permits required, the difficulty of getting credit, and so on. This is the approach adopted by the World Bank in their annual *Doing Business* report, which was started in 2002 and now covers 183 countries around the world.\(^{29}\) Their Ease of Doing Business index is an average of 10 different indicators and is widely used in cross-country comparisons.

Chart 5 below shows the Ease of Doing Business 2012 ranking of the SEE countries compared to the (unweighted) OECD average. The relative ranking within the region is quite similar to that of the GCI (above), but FYR Macedonia stands out as a top performer on this measure and holds the 22\(^{nd}\) place in the world. In contrast, Bosnia and Herzegovina is placed at the bottom on the list in the 125\(^{th}\) position. Although it is difficult to assess progress of the rankings across time due to a frequent change in the methodology, the sub-indicators have also tended to gradually improve as all SEE countries have made progress in their legislative framework, including through gradual alignment with the EU *acquis*. FYR, Macedonia and Montenegro are notable for their efforts to create a business-enabling and investment-friendly environment and both countries have implemented several “guillotine” projects in order to tackle red tape and excessive administrative barriers in recent years.

**Chart 5:** Ease of Doing Business 2012

An alternative method for assessing the quality of the business environment is to ask businesses directly about the problems they face in their day-to-day operations, and to get their subjective assessment of whether a problem is major or minor. The biggest survey of this type is the EBRD/World Bank

\(^{29}\) For further information on the methodology of the Word Bank Doing Business Report, see http://www.doingbusiness.org/.
Business Environment and Enterprise Performance Survey (BEEPS), carried out every 3-4 years across virtually all transition countries. As part of a wide-ranging questionnaire, the BEEPS presents interviewees (owners or senior executives of a company) with a list of potential obstacles and asks them to rate the severity of each one on a scale of 0 (no obstacle) to 4 (very severe obstacle).

This allows one to construct numerical averages by country and thereby get a sense of subjective perceptions of businesses about the difficulties they face. Table 1 shows the average score in 2008/9, by country, for 13 different obstacles. The final column presents the average score across countries, showing that the biggest problems at the regional level appear to be taxes (both the level and the administration), political instability and corruption. Limited access to finance was also an important impediment, even though the global crisis had not yet unfolded in the region by the time the latest round of the survey was carried out. An inadequately educated labour force and a weak court system also figure prominently among the complaints of businesses. The average size of obstacles was perceived to be higher in SEE than in CEB in the majority of cases, with the difference being particularly marked when it came to corruption, as illustrated below.30

<table>
<thead>
<tr>
<th>Obstacle</th>
<th>Albania</th>
<th>BiH</th>
<th>Bulgaria</th>
<th>Croatia</th>
<th>FYRoM</th>
<th>Montenegro</th>
<th>Romania</th>
<th>Serbia</th>
<th>SEE Average</th>
<th>CEB Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax rate</td>
<td>1.55</td>
<td>2</td>
<td>1.74</td>
<td>2.1</td>
<td>1.62</td>
<td>1.15</td>
<td>2.73</td>
<td>1.59</td>
<td>1.81</td>
<td>2.21</td>
</tr>
<tr>
<td>Political instability</td>
<td>1.97</td>
<td>2.11</td>
<td>1.61</td>
<td>1.78</td>
<td>1.71</td>
<td>0.42</td>
<td>2.17</td>
<td>2.3</td>
<td>1.76</td>
<td>1.76</td>
</tr>
<tr>
<td>Corruption</td>
<td>2.07</td>
<td>1.71</td>
<td>1.63</td>
<td>1.62</td>
<td>1.52</td>
<td>0.59</td>
<td>2.34</td>
<td>1.76</td>
<td>1.66</td>
<td>1.38</td>
</tr>
<tr>
<td>Tax admin</td>
<td>1.29</td>
<td>1.58</td>
<td>1.45</td>
<td>1.95</td>
<td>1.23</td>
<td>0.76</td>
<td>2.36</td>
<td>1.04</td>
<td>1.46</td>
<td>1.37</td>
</tr>
<tr>
<td>Access to finance</td>
<td>1.35</td>
<td>1.56</td>
<td>1.36</td>
<td>1.48</td>
<td>1.67</td>
<td>0.85</td>
<td>1.87</td>
<td>1.62</td>
<td>1.47</td>
<td>1.23</td>
</tr>
<tr>
<td>Labour Force</td>
<td>1.41</td>
<td>1.14</td>
<td>1.21</td>
<td>1.43</td>
<td>0.93</td>
<td>0.73</td>
<td>2</td>
<td>1.15</td>
<td>1.25</td>
<td>1.17</td>
</tr>
<tr>
<td>Courts</td>
<td>1.36</td>
<td>1.26</td>
<td>1.31</td>
<td>1.85</td>
<td>1.64</td>
<td>0.46</td>
<td>1.7</td>
<td>1.19</td>
<td>1.35</td>
<td>1.05</td>
</tr>
<tr>
<td>Business licensing</td>
<td>0.98</td>
<td>1.2</td>
<td>1</td>
<td>1.14</td>
<td>1.07</td>
<td>0.51</td>
<td>1.77</td>
<td>0.95</td>
<td>1.08</td>
<td>1.03</td>
</tr>
<tr>
<td>Electricity</td>
<td>2.42</td>
<td>1.03</td>
<td>1.27</td>
<td>0.7</td>
<td>1.23</td>
<td>1.27</td>
<td>1.42</td>
<td>1.1</td>
<td>1.31</td>
<td>1.32</td>
</tr>
<tr>
<td>Crime</td>
<td>0.89</td>
<td>1.08</td>
<td>1.48</td>
<td>1.38</td>
<td>1.26</td>
<td>0.4</td>
<td>1.49</td>
<td>0.92</td>
<td>1.11</td>
<td>1.27</td>
</tr>
<tr>
<td>Labour regulation</td>
<td>0.88</td>
<td>0.88</td>
<td>1.02</td>
<td>1.32</td>
<td>0.74</td>
<td>0.51</td>
<td>1.5</td>
<td>1.02</td>
<td>0.98</td>
<td>1.17</td>
</tr>
<tr>
<td>Access to land</td>
<td>1.33</td>
<td>0.65</td>
<td>0.76</td>
<td>0.77</td>
<td>1.04</td>
<td>0.43</td>
<td>1.33</td>
<td>0.9</td>
<td>0.90</td>
<td>0.81</td>
</tr>
<tr>
<td>Transport</td>
<td>0.8</td>
<td>0.76</td>
<td>1</td>
<td>0.77</td>
<td>0.84</td>
<td>0.62</td>
<td>1.23</td>
<td>0.88</td>
<td>0.86</td>
<td>0.98</td>
</tr>
<tr>
<td>Customs &amp;Trade</td>
<td>0.71</td>
<td>0.78</td>
<td>0.56</td>
<td>0.86</td>
<td>0.87</td>
<td>0.44</td>
<td>1.14</td>
<td>1.07</td>
<td>0.80</td>
<td>0.53</td>
</tr>
</tbody>
</table>


30 See Berglof et al. (2012). The exceptions, where the average size of the obstacles was lower in SEE were: crime, theft and disorder; electricity; inadequately educated workforce; labour regulations; tax rates; and transport.
Two other cross-country indices can provide important further insights into the quality of the business environment: the OECD’s Investment Reform Index (IRI), last published in 2010, and Transparency International’s Corruption Perceptions Index (CPI). The IRI looks at the ability of the region to attract investment, and assesses the institutional frameworks and policies of the countries of SEE. The evaluation is based on a qualitative evaluation of seven aspects that promote an investment-promoting environment, including policies, human capital development, access to finance and tax policies. The IRI uses a mix of inputs from the public and private sectors, as well as from independent experts, and this information is benchmarked against international best practice.\textsuperscript{31} Chart 6 shows the overall scores by country. The results show very little difference among the EU member and candidate countries of the region, with Albania and Bosnia and Herzegovina (neither yet an EU candidate) lagging behind.

![Investment Reform Index, 2010](chart6.png)

**Source:** OECD.

With regard to corruption, the most popular cross-country index is the Transparency International Corruption Perception Index (CPI), which rates the level of perceived corruption on a scale of 0 to 10, with a higher score signifying less corruption. Even in the economically more advanced countries in the SEE region, the perceived level of corruption seems to be substantially higher than in the OECD countries (see Chart 7). With a score of 4.1, Croatia and FYR Macedonia are viewed as the least corrupt countries in the region, while Albania and Bosnia and Herzegovina are perceived to be the most corrupt.

\textsuperscript{31} For further information on the methodology of the IRI, see [http://www.oecd.org/document/28/0,3746,en_2649_34893_40349212_1_1_1_1,00.html](http://www.oecd.org/document/28/0,3746,en_2649_34893_40349212_1_1_1_1,00.html).
What are the relevant strengths and weaknesses of these different approaches to measuring the business environment? The World Bank’s Doing Business (DB) report has attracted significant criticism from a number of sources, including a report from the World Bank’s own Independent Evaluation Group. The main problems, as identified in this report, include the fact that the DB is largely about laws on the books and formal regulations, rather than about their compliance and practical implementation and the operational environment more generally. Most of the indicators assume that less regulation is preferable to more, regardless of where a country is starting from. The sample size of country-level informants is sometimes very small. For these reasons (among others), the DB indicators can yield a misleading picture of the true situation. It is hard to believe that FYR Macedonia, for instance, is the 22nd easiest country to do business in globally, notwithstanding the genuine efforts in recent years of the authorities to improve the situation on the ground.

The BEEPS and the CPI have their own problems, too. They are largely survey-based, so one must be careful in making cross-country comparisons because individuals in one country may have different reference points when it comes to judging the severity of a problem compared with those in another country. For example, when it comes to rating infrastructure as an obstacle, those businesses that live in a country with very poor roads, for instance, may have adapted their mode of working over time and may not, therefore, perceive this to be an obstacle. Simultaneously, more open economies with a strong focus on exports require more trade-facilitating regulations than economies

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**Chart 7: Corruption Perception Index 2011**

Scores rank from 1 to 10, with 10 representing the best score possible.

Source: Transparency International.

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32 The report is available at: http://go.worldbank.org/SKWPK59XU0
less focussed on export activity, and therefore view obstacles to trading relatively more severely than others. Another problem is that a perceived worsening of a public good like infrastructure may reflect congestion effects in a growing economy rather than any deterioration in the inherent quality of the service. Lastly, the OECD’s IRI can be a useful tool for identifying deficiencies relating to the investment climate, but the consensual nature of the index weakens the force of the message and the absence of a similar index in other regions limits the possibility of learning from the best practice of others.

Once one allows for the limitations and possible biases of the different measures, however, a fairly clear picture emerges concerning the importance of competitiveness and business environment issues throughout the region. There is clearly a disconnection between regulatory reforms, where progress is visible in many countries (often with the encouragement and support of international institutions), and the experience of businesses on the ground. It is possible that too much emphasis has been based on ticking boxes of reforms without a deeper examination of the more fundamental causes of SEE’s relatively poor economic performance. The indicators discussed below help to bring out this point more sharply.

**Trade**

Businesses in SEE appear to have a problem with trading freely across borders. Although intra-regional trade has increased substantially in recent years and the European Union remains the region’s most important trading partner (more than 60 per cent of exports from the region go to the EU), overall trade activity remains below the level that is typically seen in economies of this size. Chart 8 compares the level of trade openness of South East European

**Chart 8: Trade Openness 2010**

Source: National authorities.
Defining a New Reform Agenda  Paths to Sustainable Convergence in South East Europe

economies to those of CEB, using the standard measure of the sum of exports and imports divided by GDP. The result shows that even in the two existing EU member states, Bulgaria and Romania, trade activity remains relatively low.

What could account for the low level of cross-border trading activity? It cannot be explained by lack of access to EU markets. Bulgaria and Romania are already fully integrated into the EU single market, and the remaining SEE region has enjoyed almost unlimited duty-free access to the EU since 2000.33 Furthermore, the non-EU member states of the region, together with Moldova and Kosovo34, are signatories of the Central European Free Trade Agreement, CEFTA 2006, which envisages the elimination of quotas, tariffs and other barriers to trade. Thus, it seems that the removal of tariffs and quotas for SEE’s key trading partners in recent years has been largely offset by more subtle obstacles to trade and non-tariff barriers (NTBs), such as sanitary and phytosanitary standards, extensive documentation and licensing requirements, and lack of available information on custom procedures. The hope is that these barriers will be alleviated over time as countries become more closely integrated with the EU.

A comparison of the World Bank’s Doing Business scores on trade and the BEEPS can provide further insight into this issue. Chart 9 shows that there is a clear distinction between countries of SEE (mostly in the right-hand ellipse) compared to CEB, with the former more constrained by formal customs and trading procedures, as measured both by the Doing Business report and by the subjective perceptions captured in the BEEPS. It is notable that the SEE

Chart 9: Obstacles to Trading Across Borders, CEB vs. SEE

![Chart 9: Obstacles to Trading Across Borders, CEB vs. SEE](image)

Source: World Bank and EBRD.

33 Exception to these EU Preferential Trade Agreements include wine, sugar, baby beef and certain fishery products, which may enter the Single Market under preferential tariff quotas. The preferential agreement for western Balkan countries was first agreed upon in 2000 and reaffirmed in January 2012.

34 Under UNSCR 1244.
countries – with the exception of Montenegro, which is positioned amongst the top 40 countries – have continuously performed poorly in the Trading Across Borders sub-indicator of Doing Business.\footnote{The Doing Business Trading Across Borders Indicator measures the amount of time, documentation and cost required to trade by ocean transport.} In addition, corruption on the border continues to be a substantial hindrance to trade.\footnote{For an elaboration of this argument, see EBRD (2010).}

**Infrastructure**

Another major factor constraining cross-border trade in SEE remains the significant infrastructure deficit. The presence of motorways remains limited even in the more advanced countries in the region, and the railway network is underdeveloped. The World Economic Forum’s Competitiveness sub-index on Infrastructure, illustrated in Chart 10, takes into account the quality of the road and railway infrastructure and air transport, electricity supply and communication technology penetration and underlines these shortcomings. With the exception of Croatia, the quality of the overall infrastructure in SEE requires significant upgrading in order to match the standards of Western Europe.

**Chart 10: Quality of Infrastructure 2011-2012**


**Skills and education**

The current structure of the economies in the SEE region is dominated by services, particularly driven by wholesale trade and retail trade and real estate, which on average accounts for more than 50 per cent of total economic activity. In addition, the production of goods and services remains at the
lower end of the value chain, largely based on cheap (relative to Western Europe) and unskilled labour. So far, little focus has been paid to shifting towards a more knowledge-based economy, that is, one where knowledge is a key engine of growth and where the appropriate institutions are in place to enable and encourage the use of existing knowledge and to foster innovation and the development of information and communications technologies.\(^{37}\)

The World Bank’s Knowledge Economy Index (KEI), presented in Chart 11, measures a country’s potential to generate knowledge and underlines the gap in this area in SEE. All countries in this region lag significantly behind the Western European average, though there are significant differences among the countries. The new EU member states Bulgaria and Romania as well as Croatia are relatively advanced in terms of developing a knowledge economy. Conversely, the knowledge economy remains at infancy in the rest of the region, notably in Bosnia and Herzegovina and Albania, thus suggesting that more efforts are needed to respond to the increasing demand for high-skilled labour.

As discussed above, the BEEPS results also highlight the prominence of the lack of skills and education as a source of problem for many businesses in SEE. This raises a question about the quality of education in the region. The OECD Programme for International Students Assessment – better known as the PISA study – suggests that the region has some catching up to do in terms of providing high quality primary and secondary education, which is the

\(^{37}\) See Chen and Dahlman (2005) for a discussion of the concept of, and methodological issues surrounding, the knowledge economy.
fundamental basis for fostering Research and Development and innovation-driven economic activity. The PISA study assesses the ability of 15-year old pupils in 65 economies in the areas of reading as well as mathematic and scientific literacy.\textsuperscript{38} Chart 12 shows that pupils in South East Europe underperform those in the OECD member states. Confirming the results of the KEI, Croatian students seem to be the most advanced in the domains assessed by PISA and have achieved results close to those of the OECD countries. However, the performance of the remaining SEE countries clearly indicates that the education gap between the region and the industrially advanced countries is sizeable.

\textbf{Chart 12: PISA Results 2009}

\begin{figure}
\centering
\includegraphics[width=\textwidth]{chart12.png}
\caption{PISA Results 2009}
\end{figure}

\textit{Source: OECD.}

\textit{Transition reforms and market-supporting institutions}

In the past two decades policy-makers across the region have attempted, with varying degrees of commitment and success, to introduce transition-related reforms, involving measures such as price and trade liberalisation, privatisation and the introduction of market forces into areas that were previously immune to such policies. At the same time, a large political economy literature has emerged that emphasises the importance of inclusive institutions as the fundamental source of long-term economic growth.\textsuperscript{39} As with many of the concepts discussed above, measuring either the extent of reforms or the quality of institutions is inherently difficult. Nevertheless,

\textsuperscript{38} Not all SEE countries are included in PISA.

\textsuperscript{39} For an overview of the literature, see Acemoglu et al. (2005). Two of these authors develop the argument, using numerous historical examples, in a recently published book (Acemoglu and Robinson, 2012).
a number of attempts have been made to impute numerical scores of reform progress to the transition countries, including those in South East Europe. More recently, efforts have been made to quantify the extent to which effective institutions are present and able to support the interplay of market forces. This section will explain how one international organisation, the EBRD, has developed numerical indicators to tackle these problems.

The EBRD’s annual transition indicators, first formulated in 1994 and refined several times since, are a well-known set of reform indicators in the region. They have been widely used in academic research that focuses on the link between reforms and other variables such as economic growth.\(^{40}\) The indicators were initially scored on a 4-point scale, from 1 to 4, where 1 represented little or no progress in reform and 4 meant that a country had made major advances in transition in a particular aspect. From 1997, pluses and minuses were added to allow for finer distinctions, meaning that 2+, for example, could be coded as 2.33 and 2- as 1.67. As of 2011, there are six country-level transition indicators: three covering aspects of enterprise reform (small-scale privatisation, large-scale privatisation, and governance and enterprise restructuring) and three relating to markets and trade (price liberalisation, trade and foreign exchange system, and competition policy).\(^{41}\)

Table 2 shows the scores for the SEE countries, along with a simple average of the six indicators. Most SEE countries perform well with regard to small-scale privatisation, price liberalisation and trade and foreign exchange system – the so-called first-stage or “market-enabling” reforms.\(^{42}\) In a number of cases, a score of 4+ has been achieved, suggesting that there is little or nothing else to do in terms of moving towards the standards of a hypothetical advanced, well-functioning market economy. The scores on the other three indicators are typically lower, and with greater variation across countries. Neither fact is surprising: reforms in these areas are harder to achieve and politically more sensitive, but the three countries in the region that are either EU members or very close to membership (Bulgaria, Romania and Croatia) have made much more progress than the remaining countries.

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40 Previous research on the link between reforms and growth using the EBRD transition indicators includes Berg et al. (1999), Havrylyshyn and Van Rooden (2000), Falcetti et al. (2002) and Falcetti et al. (2006). A more recent example is Eicher and Schreiber (2010).

41 In previous years, there were transition scores for financial markets and several infrastructure sectors, but these have now been folded into a broader set of sector transition indicators, explained in more detail later in the paper.

42 The term “market-enabling reforms”, as applied to these three indicators, was introduced in EBRD (2007).
Table 2: Country transition indicator scores 2011

<table>
<thead>
<tr>
<th></th>
<th>Albania</th>
<th>BiH</th>
<th>Bulgaria</th>
<th>Croatia</th>
<th>FYRoM</th>
<th>Montenegro</th>
<th>Romania</th>
<th>Serbia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large-scale privatisation</td>
<td>4-</td>
<td>3</td>
<td>4</td>
<td>3+</td>
<td>3+</td>
<td>3+</td>
<td>4-</td>
<td>3-</td>
</tr>
<tr>
<td>Small-scale privatisation</td>
<td>4</td>
<td>3</td>
<td>4</td>
<td>4+</td>
<td>4</td>
<td>4-</td>
<td>4-</td>
<td>4-</td>
</tr>
<tr>
<td>Governance and enterprise restructuring</td>
<td>2+</td>
<td>2</td>
<td>3-</td>
<td>3+</td>
<td>3-</td>
<td>2+</td>
<td>3-</td>
<td>2+</td>
</tr>
<tr>
<td>Price liberalisation</td>
<td>4+</td>
<td>4</td>
<td>4+</td>
<td>4</td>
<td>4+</td>
<td>4</td>
<td>4+</td>
<td>4</td>
</tr>
<tr>
<td>Trade and foreign exchange system</td>
<td>4+</td>
<td>4</td>
<td>4+</td>
<td>4+</td>
<td>4</td>
<td>4</td>
<td>4+</td>
<td>4</td>
</tr>
<tr>
<td>Competition policy</td>
<td>2+</td>
<td>2+</td>
<td>3</td>
<td>3</td>
<td>3-</td>
<td>2</td>
<td>3+</td>
<td>2+</td>
</tr>
</tbody>
</table>

Source: EBRD.

Although the EBRD’s country-level transition indicators have gained wide currency, their drawbacks have become increasingly apparent.\(^{43}\) The biggest problem is that they take insufficient account of the institutional framework surrounding private sector development and the creation of markets. While most people would agree that a successful transition involves reducing the role of the state and encouraging private ownership and market forces, it has become increasingly recognised that markets cannot function properly unless there are well-run, effective public institutions in place. That is why the EBRD developed a new set of sector-based indicators.

The new approach examines 16 sectors – covering the corporate, energy, infrastructure and financial areas – in each country and makes a judgement about the size of the remaining transition “gaps”, or challenges. That is, an assessment is made about what needs to be done, in terms of both changing the market structure and developing market-supporting institutions, to bring standards up to those of a hypothetical well-functioning market economy. The information used is a mixture of laws and regulations “on the books”, as well as a judgement about how well they are being implemented. Based on this, the transition gaps for both market structure and market-supporting institutions are classified as “negligible”, “small”, “medium” or “large”. These gap scores are then combined to give an overall numerical score to the sector, on a scale of 1 to 4+, with the exact score determined both by the data and an element of judgement.\(^{44}\)

Table 3 presents the scores for each sector in each SEE country, as well as the average regional sector transition score for CEB. Although less pronounced in the new EU member states Bulgaria and Romania, as well as Croatia, there is still a considerable gap between the CEB and SEE region.\(^{45}\) This suggests that the need for structural reforms in SEE is still significant.

\(^{43}\) See EBRD (2010), Chapter 1, and Besley et al. (2010) for a fuller discussion.

\(^{44}\) For further information on the methodology of the EBRD Sector Transition Indicators, see http://www.ebrd.com/downloads/research/transition/tr11.pdf.

\(^{45}\) See EBRD (2011b), Chapter 1, for the sector transition scores in all transition countries.
A close look at the sectorial scores reveals that the biggest gaps are in the energy sector (especially electric power and sustainable energy), the water and wastewater sector, and in the non-bank financial sector, with particularly big gaps in capital markets and private equity. The whole topic of energy efficiency and sustainability is becoming increasingly urgent in SEE, because this is a region that is likely to be affected in a major way by global warming. In the pre-crisis boom years, when foreign banks poured into the region and fought aggressively to build market share, the non-bank financial sector was somewhat neglected. It is for these reasons that many countries are making a major effort, with strong support from international financial institutions such as the EBRD, to develop local capital markets and a greater use of lending in local currency. This initiative is welcome but is likely to take time to bear fruit.

Lessons for policy-makers

The analysis has demonstrated that South East Europe is clearly lagging behind, not just in economic development but also in a range of competitiveness, business and investment environment, and institutional reform indicators. The main point of this paper is that, while we can draw lessons and useful information from each of the indicators described above, a narrow focus on a particular one to the exclusion of others could give a misleading impression of where a country stands. The real added value of these indicators comes from analysing them jointly in order to draw policy-relevant conclusions. We
Chapter 2. Making sense of competitiveness indicators in South East Europe

hope, therefore, that this paper will dissuade others from making confident assertions about the competitiveness or investor-friendliness of the region based on just one or two cross-country measures.

When all indicators are viewed simultaneously, and at the risk of simplification, it appears that a rough three-way division can be made. According to the analysis above, the best-placed economies in the region appear to be the three EU member or near-member countries (Bulgaria and Romania, as members, and Croatia, which has signed the EU accession treaty and expects to join the EU in July 2013). The three EU candidate countries (FYR Macedonia, Montenegro and Serbia), with some exceptions, follow next, while the third group consists of Albania and Bosnia and Herzegovina, both of which lag behind on most indicators. The correlation between progress on broad market reforms and EU integration, or approximation, is not a coincidence, because the EU has clearly been a vital anchor for reform throughout Central and Eastern Europe.

What advice can be offered to policy-makers beyond the general exhortation to try harder and be more like the rich western European countries? As we noted in the introduction, we do not wish to attempt to offer a comprehensive blueprint for reform in this paper, partly because this would involve a much more exhaustive and rigorous investigation of the current obstacles to investment and growth, including factors not considered explicitly in this paper such as the fiscal framework, wage and employment policy, the quality of public administration and other variables. However, there are some recommendations that can validly be drawn from the analysis above, among which are the following:

- Reform tax administration and lessen corruption by learning from other countries.

Both the Doing Business survey and the BEEPS point to problems with tax administration in the region. In the last round of the BEEPS, it was identified by businesses as the most important obstacle in five out of 29 transition countries, four of which are in SEE. However, transition countries can learn from the experience of others in this regard, and can implement reforms relatively quickly in this area. In 2000, Estonia implemented a major overhaul of its tax administration, introducing modern innovations such as e-filing of taxes, which greatly improve efficiency and reduce the scope for bureaucracy and corruption. As a result, businesses in Estonia complain very little in the BEEPS about tax administration as an obstacle. Estonia can also serve as a useful example to others in terms of successfully implementing comprehensive and effective anti-corruption policies.

- Focus on removing non-tariff barriers in order to facilitate cross-border trade and investment.

46 The four countries were Bosnia and Herzegovina, Croatia, Montenegro and Romania – see EBRD (2010, Chapter 5).

47 See EBRD (2010, Chapter 5) for further discussion of this argument and examples.
As indicated in the analysis above, trade activity in the SEE region remains below its potential and falls short of that of CEB. The umbrella of the CEFTA 2006 Secretariat serves as a useful tool to further stimulate exports and imports. Trade policy should envisage the mutual recognition of certificates and a strengthened institutional framework for accreditation, for instance. In addition, at national level, an expanded budget could be allocated to national export promotion agencies to enhance internationally accepted standards and best practises to facilitate trading across borders, while transparent and easily accessible information on trade regulations and procedural requirements should be made available to exporting enterprises. Lastly, by implementing EU required sanitary and physiosanitary measures, the region will gradually align with international standards, which will further support exports to the region’s key markets and boost its attractiveness to investors.

- Adopt a more strategic and cooperative approach to cross-border investment.

A more strategic approach is also needed both by regional governments and the international community to address the large infrastructure deficit the region is restraining, as illustrated in Chart 10. Cross-border projects to upgrade the road- and railway infrastructure, such as the pan-European corridors that run across the SEE region, already receive large support from the European Union, the EBRD and other International Financial Institutions (IFIs). The success of these large-scale IFI interventions, however, is determined by the commitment of the region’s governments to cross-border cooperation. This includes ensuring smooth and easy border crossings, cooperation of the various contractors and regional coordination of the programmes. In addition to the re-integration of South East Europe into the wider pan-European infrastructure network, however, attention must also be paid to maintaining and further developing a regional network of roads and railways in order to connect more remote areas with regional hubs, for which private sector involvement should be further encouraged. One option largely unused until present is the utilisation of EU structural and cohesion funds, that are available to the EU members Bulgaria and Romania, and soon also for Croatia. At present, both Bulgaria and Romania are struggling to absorb EU funds, although strong efforts are under way in both countries to improve the situation. In this regard, more expert help and streamlining of regulations may be required from Brussels in order to increase the absorption capacities of fund-receiving countries.

- Allocate more funds to secondary and tertiary education.

A major competitive advantage of the region in the past has been the relatively cheap labour that has attracted a number of foreign investments. However, as wages increase in the medium-term, raising the quality of the education system is crucial for moving towards a knowledge economy and enhancing the growth potential of an economy. The PISA results show that substantial shortcomings remain in the SEE educational system. Previous
research has shown that a strong focus on tertiary education in particular is required, which in the long-term generates the science and research that aids enterprises to foster innovation.\textsuperscript{48} As the scope for increasing government spending on education is limited in the short-term, the private sector may play an increasingly important role in training and skills acquisition, for instance, by enabling more on-the-job training opportunities and funding university scholarships. Lastly, the implementation of international standards on tertiary education within the framework of the Bologna Process will help the region introduce more quality assurance and curricular alignment, and should lead to increased labour market mobility.

- Mobilise funds for innovation.

The BEEPS shows that access to finance continues to be a major obstacle to business development in the SEE region, and may be preventing efforts to establish and foster innovative and export-oriented enterprises. This is particularly evident in the small and medium-sized enterprises (SMEs) sector, which numerically dominates the private sector in all SEE countries, but currently contributes little to GDP or exports. A recent example of fostering more sophistication and value-addition in the SME sector is the Western Balkan Enterprise Development and Innovation Facility (EDIF), better known as the SME Platform, which on the initiative of Serbia, the EBRD and the EIF has been established within the framework of the multi-donor-funded Western Balkan Investment Facility (WBIF). It will provide financing to innovative and high growth potential SMEs and includes a technical assistance component to help the region develop further private sector supporting policies, which in the long term will contribute to greater business sophistication in the region.\textsuperscript{49}

**Concluding remarks**

The analysis above has suggested a variety of starting points and diagnostics to tackle the shortcomings and constraints to future growth in South East Europe. It has also concluded that, on an individual basis, available competitiveness and business environment surveys have limited value for analysts and policymakers. Taken together, however, they become a valuable instrument.

Although this paper has made the deficiencies of the region clear, we believe that SEE has the potential to become globally competitive, and we have outlined several propositions to address deficits in the regulatory and institutional frameworks and obstacles to trade, as well as ways to foster a more competitive, innovative and export-oriented private sector. However, none of the above can be fully achieved without enhancing cross-border cooperation within the region, which has become increasingly prominent in recent years. A number of initiatives to promote trade, financial linkages and broader regional cooperation have already been mooted, and in some cases implemented.

\textsuperscript{48} See EBRD (2008), Chapter 3.

\textsuperscript{49} For further information, see http://www.wbif.eu/PrivateSectorDevelopment/.
In conclusion, a fully-fledged commitment by the national authorities not only to intensifying the sometimes difficult reform process, but also to maintaining good neighbourly relations and improving the cross-border exchange on best practices and lessons learned, is vital to unlock the region’s potential and to help overcome the legacy of the past.

References


Anastasakis, Othon, Jens Bastian and Max Watson, eds. (2011): From crisis to recovery: sustainable growth in South East Europe, South East European Studies at Oxford, St Antony’s College, Oxford University.


## Annex: Overview of surveys and indices used to measure competitiveness and the business environment in South East Europe

<table>
<thead>
<tr>
<th>Name</th>
<th>Source</th>
<th>Coverage</th>
<th>Frequency</th>
<th>Objective</th>
<th>Methodology</th>
<th>Main Strengths</th>
<th>Main Weaknesses</th>
</tr>
</thead>
<tbody>
<tr>
<td>World Economic Forum Global Competitiveness Index (GCI)</td>
<td><a href="http://www.weforum.org/issues/global-competitiveness">http://www.weforum.org/issues/global-competitiveness</a></td>
<td>Global, 142 countries</td>
<td>Annual</td>
<td>Provide a comprehensive measure of a country's competitiveness.</td>
<td>Uses a mix of hard data and an executive opinion survey, which includes manager's perception on competitiveness. Scores countries on a scale of 1 to 7.</td>
<td>A comprehensive mix of many different indicators relevant to a country's competitiveness.</td>
<td>Small sample size in some countries. Possible lack of objectivity of executive survey. Data quality for some parts of the index is uncertain.</td>
</tr>
<tr>
<td>World Bank Doing Business</td>
<td><a href="http://www.doingbusiness.org/">http://www.doingbusiness.org/</a></td>
<td>Global, 183 countries</td>
<td>Annual</td>
<td>Assess the regulatory framework for supporting a business-friendly environment, summarised in an Ease of Doing Business Index.</td>
<td>Gathers information on 10 indicators, covering laws, regulations and procedures, based on factual data obtained from surveys of experts on the ground. Provides ranking of countries on different indicators and on overall ease of doing business.</td>
<td>Comprehensive analysis of regulatory framework critical for a business-enabling environment.</td>
<td>No measurement of extent to which laws are actually applied. Small number of data points for certain indicators in some countries.</td>
</tr>
<tr>
<td>World Bank/ EBRD Business Environment and Enterprise Performance Survey (BEEPS)</td>
<td><a href="http://www.ebrd.com/pages/research/analysis/surveys/beps.shtml">http://www.ebrd.com/pages/research/analysis/surveys/beps.shtml</a></td>
<td>Regional, 29 countries in the Transition Region</td>
<td>Periodic – usually every 3-4 years (last round in 2008-09).</td>
<td>Measure the overall quality of the business environment and the severity of obstacles, as perceived by owners and senior managers of enterprises.</td>
<td>Survey-based, assessing perceptions of more than 11,800 enterprises in the last round. Obstacles can be coded on a five-point scale from 0 (no obstacle) to 4 (very severe obstacle).</td>
<td>Captures the reality of business environment problems as perceived by businesspeople on the ground.</td>
<td>Cross-country comparisons are problematic because of different reference points. Subjective opinions may be only loosely related to objective conditions.</td>
</tr>
<tr>
<td>Name</td>
<td>Source</td>
<td>Coverage</td>
<td>Frequency</td>
<td>Objective</td>
<td>Methodology</td>
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<tr>
<td>OECD Investment Reform Index (IRI)</td>
<td><a href="http://www.oecd.org/document/28/0,3746,n_2649_34893_403492121_1_1_1,00.html">http://www.oecd.org/document/28/0,3746,n_2649_34893_403492121_1_1_1,00.html</a></td>
<td>Regional, 10 countries in South East Europe</td>
<td>2006, 2010</td>
<td>Assess eight policy dimensions that shape investment policies, including, investment promotion policy, human development, SME development and infrastructure for investment.</td>
<td>Uses a mix of government self-assessment, independent expert groups and working groups with private sector representatives to score policy developments in each dimension from 1 - 5.</td>
<td>Strong focus on investment and synthesises a range of views about the necessary reforms.</td>
<td>Consensual nature of discussions can lead to bland policy recommendations. No obvious benchmark outside SEE.</td>
</tr>
<tr>
<td>TR Corruption Perception Index (CPI)</td>
<td><a href="http://cpi.transparency.org/cpi2011/results/">http://cpi.transparency.org/cpi2011/results/</a></td>
<td>Global, 183 countries</td>
<td>Annual</td>
<td>Measure the perceived level of corruption.</td>
<td>Survey-based, assessment of perceptions, drawing on 17 data sources from 13 institutions on a scale from 0 (most corrupt) to 10 (no corruption).</td>
<td>Only index of its kind and uses a variety of perception surveys.</td>
<td>Possible lack of objectivity. Uses only proxies for corruption.</td>
</tr>
<tr>
<td>World Bank Knowledge Economy Index (KEI)</td>
<td><a href="http://info.worldbank.org/etools/kam2/KAM_page5.asp">http://info.worldbank.org/etools/kam2/KAM_page5.asp</a></td>
<td>Global, 146 countries</td>
<td>Annual, 1995-2009</td>
<td>Assess a country’s ability to generate and adopt knowledge.</td>
<td>Based on 14 variables along four pillars: economic performance; economic incentive and institutional regime; education and human resources; and innovation systems. Includes quantitative data and a mix of other existing indices. Scale from 0 to 10.</td>
<td>Useful mixture of sources and information relevant to an increasingly important sector.</td>
<td>No longer updated. Great variety of different methodologies, making cross-country comparisons difficult.</td>
</tr>
<tr>
<td>Name</td>
<td>Source</td>
<td>Coverage</td>
<td>Frequency</td>
<td>Objective</td>
<td>Methodology</td>
<td>Main Strengths</td>
<td>Main Weaknesses</td>
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</tr>
<tr>
<td>OECD PISA</td>
<td><a href="http://www.pisa.oecd.org/pages/0,2987,en_322,52351_32235731_1_1_1_1_1_00.html">http://www.pisa.oecd.org/pages/0,2987,en_322,52351_32235731_1_1_1_1_1_00.html</a></td>
<td>Global, 75 countries</td>
<td>Triennial</td>
<td>Measure the quality of the secondary education system</td>
<td>Assignment-based, assessing the ability in reading, mathematics and science of more than 520,000 15-year old students in the last round. Scores for each indicator are based on a scale of 0 to 600.</td>
<td>Especially useful for cross-country comparison. High level of objectivity. Studies show the results have strong predictive power for long-run economic growth.</td>
<td>Not all SEE countries covered. Neglects aspects of educational attainment, such as vocational training.</td>
</tr>
<tr>
<td>EBRD Country Transition Indicators</td>
<td><a href="http://www.ebrd.com/pages/research/economics/data/macro.shtml">http://www.ebrd.com/pages/research/economics/data/macro.shtml</a></td>
<td>Regional, 29 countries in the Transition Region</td>
<td>Annual</td>
<td>Summarise a country's progress to a well-functioning market-based economy on broad, country-level indicators.</td>
<td>Uses a mixture of factual information and judgement to score countries, on a scale of 1 to 4+, for progress on small- and large-scale privatisation, price and trade liberalisation, corporate governance and competition policy.</td>
<td>Handy snapshot of a country's progress in transition. Empirical evidence suggests the indicators can help predict other variables such as economic growth.</td>
<td>Insufficient attention to the institutional framework necessary for markets to function.</td>
</tr>
<tr>
<td>EBRD Sector Transition Indicators</td>
<td><a href="http://www.ebrd.com/pages/research/economics/data/macro.shtml">http://www.ebrd.com/pages/research/economics/data/macro.shtml</a></td>
<td>Regional, 29 countries in the Transition Region</td>
<td>Annual</td>
<td>Measure progress towards the standards of a well-functioning market economy in 16 different sectors.</td>
<td>Uses a range of data, combined with judgement, to rate progress in reform, on a scale of 1 to 4+, in 16 different sectors, covering the corporate, infrastructure, energy and financial sectors. Scores are based on an assessment of the transition gaps in both market structure and market-supporting institutions.</td>
<td>Detailed sectoral assessment can help identify significant transition gaps and investment needs by sector.</td>
<td>Scoring system still has a strong element of subjectivity. Link between closing transition gap in a sector and boosting economic growth is unclear.</td>
</tr>
</tbody>
</table>
Chapter 3. Trade openness and growth in South East Europe

Bas B. Bakker and Jesmin Rahman

Introduction

There is a widespread belief among economists that economies that are open to trade grow faster than closed economies. Strong theoretical support backs the premise that increased trade leads to higher incomes, upon which this belief is based, and is grounded in classical, neoclassical and endogenous growth theory. Trade, for example, allows producers to access bigger markets and encourages the development of R&D through increasing returns to innovation.

Superficially, economies in SEE seem very open. They meet the definition of a “small open economy” – an economy that trades with other countries, but that is small enough compared to the world markets in which it participates that its policies do not alter world prices, interest rates, or incomes. However, as explored in this Chapter, economies in SEE are not as open to trade as economies in other parts of emerging Europe. Their export to GDP ratios are well below those of central Europe and the Baltics, and they export less than what would be expected, given their small size.

Low openness is partly the result of historical factors (late macro-stabilization and civil conflicts), but more recent policies (slow reforms and macro policies that paid insufficient attention to high wage growth) have played a role as well.

Low trade openness matters. Without a larger role of exports, growth in SEE is likely to remain low. Growth was rapid in the pre-crisis boom years, but the pre-crisis GDP growth model was not sustainable – it was mostly driven by domestic demand and the non-tradable sector, with too little contribution from exports.

50 Bas B. Bakker is the Division Chief of, and Jesmin Rahman a senior economist in, the Emerging Europe Regional Division of the European Department in the International Monetary Fund. The views expressed in this Chapter are those of the authors and should not be attributed to the IMF, its Executive Board, or its management.
Trade openness in SEE

Trade openness measures can be divided into two broad categories: measures of trade intensity (the ratio of trade, exports or imports to GDP) and measures of trade restrictions. This paper focuses on trade intensity measures, as most countries in emerging Europe have few trade tariff-related restrictions left. Of the trade intensity measures, we prefer the export to GDP ratio. This is because in many countries, imports have gone through severe boom-bust cycles – the result of the boom and bust in capital inflows rather than changes in openness.

Compared to other countries in emerging Europe, the export-to-GDP ratio in SEE is low, and has increased less in the past decade (Figure 1).

- The level of the exports-to-GDP ratio is well below that of Central Europe and the Baltics. There are differences, though, among countries: Albania, Serbia, Romania, Bosnia and Herzegovina and Montenegro have particularly low exports-to-GDP ratios, while the ratio is relatively high in Bulgaria.

- The change in the exports-to-GDP ratio during the pre-crisis years has also been lower than that in Central Europe, although it has been somewhat higher than that in the Baltics. Again, there are important cross-country differences: in Romania, the exports-to-GDP ratio declined between 2000 and 2008, and in Croatia it remained flat, while in Bulgaria, Bosnia and Herzegovina and Albania it increased noticeably – although not as much as in Central Europe.

Moreover, this measure of openness may overstate the openness of the SEE economies, as their low domestic price levels and small size tend to increase their exports-to-GDP ratio relative to other countries.

- Price levels are generally lower in poorer economies, as lower wage costs lead to lower prices of services. The lower price level reduces the size of nominal GDP, which increases the exports-to-GDP ratio.

- Smaller countries tend to have a higher trade-to-GDP ratio. If all firms trade within a 200-kilometre radius, in a large country most of the trade will take place domestically, while in a small country much of it will be exports and imports.

To correct for the price level and size, we use a methodology proposed by Tang (2011) in which trade openness (exports plus imports over GDP) is thought to be a function of a country’s own GDP as well as the GDP of all

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52 To see this, assume that countries produce haircuts and computers. The price of computers will probably not differ much between rich and poor countries, but the price of haircuts will be lower in poor countries. If a rich and a poor country produce the same number of computers and haircuts, the value of nominal GDP will be higher in the rich country.
its potential trade partners. Using this measure, the SEE sub-region looks more closed compared to other emerging European countries (Figure 2). For example, while the SEE region is about half or more as open as the CEE region in 2008 based on the simple exports-to-GDP ratio, it is half or less as open as the CEE region using the corrected openness measure.

Lower openness also becomes evident through a model that links a country’s trade to its internal market size (population), institutional development (per capita GDP) and distance from the closest major market. We use the model’s estimates to compare actual trade with what could be expected in emerging Europe. Given the closer trade integration of Europe than in many other regions, we would expect trade in European countries to be higher than the average for the entire sample. However, this is not the case for SEE. In 2008, trade in the SEE region was more in line with what is predicted based on the entire sample of 149 countries, while the CEE sub-region’s level of trade was twice as much as the model’s predicted level and that of the Baltic region was more than one and a half times as much as the trade level predicted by the model (Figure 3). Thus, relative to other countries in emerging Europe, SEE countries come out again as relatively closed.

**Low export intensity and the pre-crisis growth model**

At first sight, the low trade openness of SEE does not seem to matter, as in the past decade, SEE has grown rapidly. Between 2000 and 2010, per capita real GDP grew by four per cent annually (Figure 4). Growth was particularly rapid in the two EU member states, Bulgaria and Romania (4.5%), but was strong in Albania and respectable in the other non-EU member states as well (3.5%).

However, the rapid growth of the SEE sub-region should not be surprising given the low income levels in the region. Economic growth theory suggests that poorer countries should grow faster, a process called ‘convergence’. Growth theory identifies two factors that drive convergence: diminishing returns in the accumulation of capital and cross-country knowledge spillovers. Poorer countries usually have a lower capital stock, and therefore, higher marginal productivity of capital. Thus, increases in capital stock will have a large impact on output. Poorer countries can also boost output by

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53 The estimated parametric relationship is as follows:

\[ \text{Trade openness} = \frac{(X+M)}{((\text{GDP}_{i}^{(-0.2)})+(\text{GDP}_{row}^{(-0.2)}))^{(-5)}}. \]

Where, X and M are real exports and import of goods and services; GDP\(_{i}\) and GDP\(_{row}\) are a country’s own GDP and rest of the world’s GDP (in constant PPP).


54 Using a sample of 149 countries, the following empirical relationship is estimated between openness and the explanatory variables:

\[ \frac{(X+M)}{\text{GDP}} = 34.92 - 3.45 \ln(\text{population}) + 11.45 \ln(\text{PPP GDP/capita}) - 6.06 \ln(\text{distance from major market}) \]

Using these coefficients, we estimate how much a country should trade and express it as a ratio to actual trade.

imitating technologies already developed in wealthier and more advanced countries – a process that will raise total factor productivity (TFP).

Indeed, once we take into account the low initial income level in the region, growth was less impressive. If we compare the actual real per capita GDP growth with what could be expected given the initial income levels, we see that growth in SEE countries was in line with, or even somewhat below, expectations (Figure 5).

Most important, the pattern of GDP growth – fuelled by domestic demand, concentrated in the non-tradable sector, and with a very limited role of exports – was unsustainable and contributed to large imbalances and vulnerabilities. The contribution of real exports to GDP growth was lower in SEE than in central Europe (CEE) and the Baltics. Within SEE, it was particularly low in the non-EU countries (Figure 6). With large capital inflows, and limited growth of exports, current account deficits in many SEE countries were high, external debt was elevated, and foreign currency balance sheet mismatches were considerable. Growth became too dependent on the continuation of large capital inflows, and once these flows slowed down after the default of Lehman, the rapid growth turned into a sharp recession in most countries.

**Why trade openness matters**

The relative degree of trade integration seems to differentiate countries with high growth from those with slow growth.\(^{55}\) It is striking how many of the strong performers in Europe have enjoyed high and increasing levels of trade, both in exports and in imports, and how many of the poor performers have had much lower and stagnating levels, with growth driven more by the non-tradable sectors.

- In advanced Europe, such as in Austria, Germany, the Netherlands, and Sweden, the share of exports and imports in GDP rose by about 15 per cent to more than 20 per cent between 1995 and 2010. At the other end of the spectrum, the export-to-GDP and import-to-GDP ratios of Greece, Italy, Portugal, and Spain stagnated over those years (Figure 7).

- The same phenomenon can also be observed in emerging Europe. Countries that have shown fast and sustained convergence, such as the Czech and Slovak Republics, and, to a lesser extent, Poland, the exports-to GDP ratio has steadily increased over time. In South East Europe, there has been much less increase, and the level of exports is generally lower than that in Central Europe.

- Between 2000 and 2010, there has been a positive link between the increase in the exports-to-GDP ratio and convergence-adjusted real GDP growth (Figure 8). Europe is not an exception.

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\(^{55}\) See IMF, Regional Economic Outlook Europe, Navigating Stormy Waters, October 2011, Chapter 3.
Chapter 3. Trade openness and growth in South East Europe

Seen over a longer time period, sustained growth seems to be linked with export-led growth and increased openness. Globally, countries that have gone through high and sustained growth spurts have done so by relying heavily on exports and maintaining a high investment ratio financed mostly by high domestic savings and FDI. Similarly, empirical studies show a strong, significant positive relationship between openness and the rate of income convergence.

**Why is SEE so closed in terms of export intensity?**

The low share of exports in GDP in the SEE sub-region is partly the result of historical factors: longer macro instability, civil conflicts and lack of EU membership. However, more recent policies, including slower progress in completing the transition from a planned economy to a market economy, and macro policies that paid insufficient attention to high wage growth are likely to have contributed as well.

**Historical factors**

SEE was late in reaching macro stability. Average inflation in the sub-region stayed in the double digits until 2002/03, and growth remained volatile in the first decade of transition (Figure 9). Industrial production continued to fall until 1995, and unemployment remained as high as 36 per cent (Macedonia) in the mid-1990s.

In the Western Balkans, the situation was exacerbated by civil and military conflicts, which caused deindustrialization, social fragmentation, nationalism, political turmoil and prolonged macroeconomic instability. Countries remained isolated from the world economy, reforms were held back and EU membership prospects were pushed back. As a result, capital inflows were low and crucial foreign investments were kept out, stunting exports prospects of these economies. It was not until the democratic changes in Croatia and Serbia in 2000 that the region began to fully engage with the international economy. By then, many of the West European multinationals had already made their decisions concerning the locations of factories.

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56 There are 13 developing countries that have managed to grow for 25 years or more at an average rate of seven per cent or more on a per capita basis, attesting to this experience. See The Next Convergence: The Future of Economic Growth in a Multispeed World, by Michael Spence, Farrar, Straus and Giroux, New York, 2011.

57 Using a sample of 127 pairs of countries on the basis of export data, and 134 pairs on the basis of imports data, an increase in trade between major trade partners is found to be related to an increase in the rate of convergence between the pairs. See Trade and Income Convergence, Dan Ben-David and Ayal Kimhi, NBER Working Paper No. 7642, April 2000.

Civil and military conflicts also pushed back EU membership in the Western Balkans, further discouraging foreign investment, including in the export sector. Bulgaria and (to a lesser extent) Romania experienced a surge in FDI inflows after EU membership was agreed upon in 2004. By 2007, the stock of FDI in Bulgaria was higher than in all other emerging European countries.

**Policy factors**

Civil and military conflicts further stalled reforms. In 2000, the SEE region, and particularly the non-EU members, significantly trailed behind other regions in EBRD transition indicators (Figure 10). The gap was not closed in later years. In 2010, SEE, and, in particular, the non-EU members, continued to lag behind other regions.

The lack of reforms is likely to have affected GDP growth. Empirical studies suggest institutional and structural reforms to be a stronger determinant of growth in transition countries than initial conditions or macroeconomic variables (Berg and others 1999).

It may also have affected exports, as the lag in reforms vis-à-vis other countries was higher in areas more relevant to the tradable sector, such as in competition policy, enterprise reform and infrastructure development. SEE countries have made less progress in improving physical infrastructure, using information and communication technology, improving the business and regulatory environment and in enterprise reform – factors that seem to be linked to the region’s lower exports-to-GDP ratio (Figure 11). Exports are further impeded by protracted customs regulations, which are a bigger problem in SEE than in other regions (Figure 12).

Other factors exist as well, although some of them are more country specific. Table 1 draws on the EBRD/World Bank Business Environment and Enterprise Performance Survey, which contains valuable evidence about the subjective perceptions of owners and senior managers across the region (see also Chapter 2). The table shows the five biggest obstacles businesses face in different SEE countries. In most countries, firms mention the high level of informal economy (a legacy of civil conflicts) and access to finance as common obstacles. Other factors are more country-specific. For example, electricity availability in Albania and Montenegro, political instability in Bosnia and Serbia, licenses and permits in Montenegro, and inadequately trained labour in Romania are considered to obstruct the business environment.

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59 Among the non-EU members, Croatia has recently concluded its accession negotiations and is set to join the EU in 2013. Macedonia is a candidate country, while Albania, Serbia, Bosnia and Kosovo are potential candidates.

A third factor that may have held back export growth is rapid wage growth. In a number of countries, including Bulgaria, Montenegro, Romania, and Serbia, annual nominal wage growth was in the double digits between 2002 and 2008 (Table 2), albeit from a low level in some cases. In Bulgaria and Montenegro, this was not compensated by exchange rate depreciations, as there was either a currency board (Bulgaria) or the euro was the legal tender (Montenegro). Romania had a more flexible exchange rate, but between 2004 and mid-2007, the nominal exchange rate appreciated by 25 per cent, exacerbating extant pressures on competitiveness.

While data on unit labour costs exist for only a subset of countries, it is striking that for these countries there is a strong link between the rise of unit labour costs (ULC) and the change in the exports-to-GDP ratio (Figure 13). In those countries where ULC grew rapidly, the exports-to-GDP ratio increased very little or even declined, while in countries where unit labour costs were more contained, there was a much stronger increase in this ratio.

The rapid rise of wage costs in a number of countries in SEE has been particularly problematic, as these countries had not yet moved up the quality ladder. In Bulgaria, Romania, FYR Macedonia, and Albania, the share of clothing in manufacturing in the mid 2000s was much higher than that in central Europe and had also not changed much compared with a decade earlier (Figure 14). At the same time, the share of capital goods in total exports was low.
The rapid rise of wage costs partly reflects convergence with higher wage levels in advanced Europe, but macro policies that paid too little attention to overheating are likely to have contributed as well.

- Monetary policy was constrained in a number of countries by the exchange rate regime (Bulgaria, Croatia, and FYR Macedonia), or due to unilateral adoption of the euro (Kosovo and Montenegro).

- In many countries, fiscal policy exacerbated rather than reduced wage pressures, as public expenditure grew very rapidly. During the boom years, public finances looked good, as domestic booms led to a surge in fiscal revenues (Figure 15). This situation created the illusion of fiscal space, at a time when fiscal policy needed to play a much stronger countercyclical role. The large increases in pre-crisis public expenditure growth further fuelled overheating; it also set the stage for large deficits when part of the revenue surge turned out to be temporary.

Conclusions

Economies in SEE are not as open to trade as economies in other parts of emerging Europe. Their export to GDP ratio is well below that in central Europe and the Baltics; and they export much less than what would be expected given their small size.

Low openness is partly the result of historical factors (late macro stabilization and civil conflicts), but more recent policies (slow reforms and macro policies that paid insufficient attention to high wage growth) have played a role as well.

Low trade openness matters: without a larger role of exports, growth in SEE is likely to remain low. Growth was rapid in the pre-crisis boom years, but the pre-crisis GDP growth model was not sustainable – it was mostly driven by domestic demand and the non-tradable sector, with too little contribution from exports.

What needs to be done to foster increased openness? A key priority is to accelerate the EU accession process in the “potential candidate” countries through faster reforms. Experience in the new member states of the EU shows that accession can work as a powerful force to draw in foreign capital, increase trade integration and enhance long term growth prospects. Pushing reforms in the areas of competition policy, enterprise reforms, customs regulations, and improving the quality of the basic infrastructure is also crucial. To avoid the pitfalls of the boom years, macro policies will need to play a much stronger countercyclical role, to ensure that wage costs do not accelerate too much.

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61 A recent study shows that Europe’s high financial integration, which has been the source of growth, is a result of the high level of political integration facilitated by EU accession. Accession creates an environment of political and economic stability, which in turn makes investors interested to engage in long-term projects. See Financial Integration and Growth – Is Emerging Europe Different? By Christian Friedrich, Isabel Schnabel and Jeromin Zettelmeyer, EBRD Working Paper No. 123, December 2010.
Chapter 3. Trade openness and growth in South East Europe

Figures

Figure 1. SEE Is The Least Open Sub-Region in Emerging Europe

Source: IMF, World Economic Outlook database.
Figure 2. Differences in Openness Are Even Larger When Corrected for Price Level and Size¹


¹Exports and imports as a weighted share of a country's own and trading partner's GDP using Tang (2011).

Figure 3. A Fundamentals-Based Assessment Also Makes SEE the Least Open Sub-Region in Emerging Europe²


²The ratio of actual and estimated trade intensity estimated using Broadman (2006).
Figure 4. Growth Was Strong During The Last Decade

Source: IMF, World Economic Outlook database.
Defining a New Reform Agenda  Paths to Sustainable Convergence in South East Europe

Figure 5. Rapid Growth Was Mostly Explained by Convergence

Source: IMF, World Economic Outlook database.

¹ Data for Montenegro and Malta are for 2000.
² The adjusted growth measures the difference between each country’s actual growth rate and the growth rate that could be expected given initial income levels.
Chapter 3. Trade openness and growth in South East Europe

Figure 6. Foreign Capital Drove Growth, with Low Contribution from Exports

Source: IMF, World Economic Outlook database.

Note: Central Europe includes Czech Republic, Hungary, Poland and Slovak Republic; Southeasten Europe-non-EU includes Albania, Bosnia and Herzegovina, Croatia, Macedonia, FYR, Montenegro, Rep. of, and Serbia; Southeastern Europe-EU includes Bulgaria and Romania; Baltics includes Estonia, Latvia and Lithuania.

¹ 2001–07 instead.
Figure 7. Selected EU Countries: Trade Openness, 1995–2010  (Percent of GDP)

Source: IMF, World Economic Outlook database.
Figure 8. Higher exports led to higher convergence-adjusted growth

![Graph showing adjusted change in real GDP per capita, 2000–10, annualized.](image)

Source: IMF, World Economic Outlook database.

Figure 9. Macro stability was restored later in the region

![Graph showing annual CPI inflation (Percent change) and real GDP growth, annual (percent change).](image)

Source: IMF, World Economic Outlook database.

Figure 10. SEE region started late in transition and did not catch up

![Graph showing annual CPI inflation (Percent change) and real GDP growth, annual (percent change).](image)

Source: European Bank for Reconstruction and Development
Figure 11. Weaker institutions have hampered growth in the SEE sub-region


Figure 12. Cumbersome trade regulations have not helped

Data Source: The World Bank, Trade Facilitation Database.
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**Figure 13.** Change in Unit Labor Costs and Change in Exports to GDP ratio

![Graph showing the relationship between change in unit labor costs and change in exports to GDP ratio.](image)

The graph illustrates the correlation between change in unit labor costs (ULC) and change in exports to GDP ratio for countries in South East Europe, represented by specific markers for each country. The equation of the line of best fit is provided:

\[ y = -0.1281x + 16.775 \]

with an R² value of 0.7684. The points for each country are marked on the graph: Bulgaria, Czech Republic, Hungary, Latvia, Poland, Romanian, Slovak Republic, and Sweden.

**Figure 14a.** Exports in SEE remained stuck in low value-added products

![Bar chart showing the share of clothing in total manufacturing exports.](image)

The chart displays the share of clothing in total manufacturing exports for various countries in South East Europe, categorized by different time periods (mid-1990s, mid-2000).

**Figure 14b.** Exports in SEE remained stuck in low value-added products


**Figure 15.** Emerging Europe: Cumulative Change in Real Domestic Demand and Real Fiscal Revenue, 2003–08 (Percent)

Sources: IMF, World Economic Outlook database and Government Finance Statistics; and IMF staff calculations.

1As the boom in the Baltic states ended in 2007, data for the Baltics refer to 2002–07.
Chapter 4. Financial constraints on economic growth in South East Europe

Fikret Čaušević

Introduction

With the advent of the global and then euro area crises, striking changes have been taking place in the role of the financial sector across South East Europe. Surveys of managers by the World Economic Forum (discussed below) suggest that access to financing has become one of the most problematic factors for doing business and for investment activity in the region. Indeed, lack of such access is now the greatest barrier to doing business in four of the region’s countries, and among the most serious factors in a further four. In none of these countries was access to financing one of the top five barriers in 2008. This chapter explores aspects of this issue, including the need to develop domestic capital markets with an adequate presence of risk-free assets.

Competitiveness and access to finance

One of the best-known reports on business and economic policy is the World Economic Forum’s Global Competitiveness Report (GCR), the broad features of which were discussed in Chapter 2 of this book. The findings of this report in recent years are worth analysing in some more detail here as they provide interesting insights into the evolving role of the financial sector in South East Europe. The business environment analysis, which is based on surveys of managers (soft data) and on statistical data (hard data), provides a reasonable basis for further analysis of how the micro and macro environments interact in creating economic competitiveness and long-term sustainability. The rankings of countries in South East Europe have undergone some striking changes, and this is true also of the significance of potential financing constraints.

In the 2011-12 GCR, Montenegro was the highest-ranked SEE country, albeit 11 positions lower from its standing in the previous year. Albania’s overall competitiveness ranking increased 18 places over the previous three years, while Croatia dropped 4 places. Bosnia and Herzegovina was the lowest ranked country in the region. However, unlike Croatia and Serbia, whose
competitiveness rankings dropped, Bosnia and Herzegovina’s position had improved 9 places over the previous three years. In the previous two years, Bulgaria’s ranking dropped 3 places, while Romania’s ranking decreased 10 places. It is interesting to note that high indebtedness has not necessarily implied a low ranking: the GCR did rank some highly indebted countries relatively favourably in the period prior to and after the global crisis.62

Table 1. Competitiveness of SEE Countries

<table>
<thead>
<tr>
<th>Country</th>
<th>2011-12 (out of 142)</th>
<th>2010-11 (out of 139)</th>
<th>2009-10 (out of 133)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Albania</td>
<td>78</td>
<td>88</td>
<td>96</td>
</tr>
<tr>
<td>Bosnia and Herzegovina</td>
<td>100</td>
<td>102</td>
<td>109</td>
</tr>
<tr>
<td>Croatia</td>
<td>76</td>
<td>77</td>
<td>72</td>
</tr>
<tr>
<td>Macedonia FYR</td>
<td>79</td>
<td>79</td>
<td>84</td>
</tr>
<tr>
<td>Montenegro</td>
<td>60</td>
<td>49</td>
<td>62</td>
</tr>
<tr>
<td>Serbia</td>
<td>95</td>
<td>96</td>
<td>93</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>74</td>
<td>71</td>
<td>76</td>
</tr>
<tr>
<td>Romania</td>
<td>77</td>
<td>67</td>
<td>64</td>
</tr>
<tr>
<td>Greece</td>
<td>90</td>
<td>83</td>
<td>71</td>
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<tr>
<td>Turkey</td>
<td>59</td>
<td>61</td>
<td>61</td>
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</table>


The managers’ survey conducted by the World Economic Forum provides information about opinions on barriers to doing business. Comparing the five factors that they ranked as most problematic during the past three years, it striking how much managers’ opinions have changed. In four Western Balkan countries (Albania, Bosnia and Herzegovina, FYR Macedonia, and Montenegro), access to financing is now the biggest obstacle to doing business. Three years ago it was not regarded as a significant barrier in any of them. Access to financing is now the third most problematic impediment to doing business in Serbia. In fact, Croatia is the only Western Balkan country in which this factor was not considered one of the five major barriers to doing business last year.

To put this finding into perspective, the other factors most frequently cited as major barriers to doing business are the tax rates, tax system, inefficient government bureaucracy and corruption. In terms of the influence of the global financial cycle on economic growth rates, and managers’ attitudes as to which “economic” and “non-economic” factors represent the most significant barriers to doing business, the data in the tables below suggest that access to financing was not considered a problem. On the other hand, factors like the quality of institutions and governance were deemed highly problematic – as long as there was high loan activity by internationally active banks, the most significant of which for the Western Balkans were from Austria, Italy, France, Slovenia and Greece.

Table 2. The most problematic factors for doing business in SEE

<table>
<thead>
<tr>
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<th>2.</th>
<th>3.</th>
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<tbody>
<tr>
<td><strong>Albania</strong></td>
<td>Access to financing</td>
<td>Tax rates</td>
<td>Corruption</td>
<td>Tax regulations</td>
<td>Ineff.Gov. Bureaucracy</td>
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<tr>
<td><strong>2011</strong></td>
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<td><strong>Albania</strong></td>
<td>Corruption</td>
<td>Inad.supply of infrastr.</td>
<td>Ineff.Gov. Bureaucracy</td>
<td>Tax regulations</td>
<td>Tax Rates</td>
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<td><strong>2008</strong></td>
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<td>Access to financing</td>
<td>Tax rates</td>
<td>Ineff.Gov. bureaucracy</td>
<td>Corruption</td>
<td>Tax regulations</td>
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<td><strong>Herzegovina</strong></td>
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<td><strong>2011</strong></td>
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<td><strong>Bosnia and</strong></td>
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<td>Policy instability</td>
<td>Ineff.Gov. bureaucracy</td>
<td>Inadequate supp. of infrastr.</td>
<td>Corruption</td>
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<td><strong>Herzegovina</strong></td>
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<td><strong>2008</strong></td>
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<td><strong>Croatia</strong></td>
<td>Ineff.Gov. bureaucracy</td>
<td>Corruption</td>
<td>Policy instability</td>
<td>Tax rates</td>
<td>Corruption</td>
</tr>
<tr>
<td><strong>2011</strong></td>
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<tr>
<td><strong>Croatia</strong></td>
<td>Ineff.Gov. bureaucracy</td>
<td>Corruption</td>
<td>Tax regulations</td>
<td>Inadeq.edu. workforce</td>
<td>Access to financing</td>
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<tr>
<td><strong>2008</strong></td>
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<tr>
<td><strong>Macedonia</strong></td>
<td>Access to financing</td>
<td>Ineff.Gov. bureaucracy</td>
<td>Inadeq.edu. workforce</td>
<td>Poor work ethic</td>
<td>Corruption</td>
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<td><strong>FYR 2011</strong></td>
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<tr>
<td><strong>Macedonia</strong></td>
<td>Policy instability</td>
<td>Ineff.Gov. bureaucracy</td>
<td>Access to financing</td>
<td>Poor work ethic</td>
<td>Corruption</td>
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<td><strong>FYR 2008</strong></td>
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<td><strong>2011</strong></td>
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<td>Inadeq.supp of infrastr.</td>
<td>Inad.educat. workforce</td>
<td>Restrictive labor regul.</td>
<td>Poor work Ethic</td>
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<tr>
<td><strong>2008</strong></td>
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<tr>
<td><strong>Serbia</strong></td>
<td>Ineff.Gov. bureaucracy</td>
<td>Corruption</td>
<td>Access to financing</td>
<td>Inflation</td>
<td>Governm. Instability</td>
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<td><strong>2011</strong></td>
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<tr>
<td><strong>Serbia</strong></td>
<td>Policy instability</td>
<td>Corruption</td>
<td>Ineff.Gov. bureaucracy</td>
<td>Inadeq.supp of infrastr.</td>
<td>Crime and theft</td>
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<tr>
<td><strong>2008</strong></td>
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</tbody>
</table>
In Bulgaria and Romania, access to financing also emerged as one of the top five barriers to doing business (fourth largest) in the GCR, 2011-12. Three years ago, this factor was no even on the list. In both these countries, however, political factors such as corruption and inefficient government bureaucracy are amongst the top five cited impediments to doing business, which is somewhat surprising given that both Bulgaria and Romania are EU members.

Table 3. The most problematic factors for doing business in SEE

<table>
<thead>
<tr>
<th>Factor</th>
<th>1.</th>
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<th>5.</th>
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</thead>
<tbody>
<tr>
<td>Romania 2008</td>
<td>Policy instability</td>
<td>Tax rates</td>
<td>Tax regulations</td>
<td>Inefficient gov.bureau.</td>
<td>Inadequate supp.of infrastruct.</td>
</tr>
</tbody>
</table>

Along with the spill over of the global financial crisis from Western Europe to SEE, access to financing is now the second largest barrier to business in Greece, even if three years ago managers there did not consider it one of the top five. By contrast, managers in Turkey singled out tax rates and the tax system.

Table 4. The most problematic factors for doing business in Greece and Turkey

<table>
<thead>
<tr>
<th>Factor</th>
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</tr>
</thead>
<tbody>
<tr>
<td>Turkey 2011</td>
<td>Tax rates</td>
<td>Ineff.Gov. bureaucracy</td>
<td>Tax regulations</td>
<td>Inadequatel. Educat.work</td>
<td>Foreign currency regulations</td>
</tr>
<tr>
<td>Turkey 2008</td>
<td>Ineff.Gov. bureaucracy</td>
<td>Tax Regulations</td>
<td>Policy instability</td>
<td>Access to financing</td>
<td>Tax rates</td>
</tr>
</tbody>
</table>
Evidence from credit activity

This finding of a reversal in financing conditions is confirmed by an analysis of changes in credit activity (loans extended) between 2004 and 2010. In the four SEE countries whose managers ranked financing as the main problem in the last survey, we find a decline in lending, along with associated problems. Figure 4 shows the changes in credit activity, in the total value of assets, and in nominal GDP growth rates in Albania and FYR Macedonia for 2005-2010. Credit activity in Albania was most intense in 2005, when loans to enterprises rose 72% and loans to households nearly 80% over the previous year. Credit expansion continued between 2006 and 2007. A sharp decline in growth was recorded from 2009 to 2010, with a concomitant increase in the share of NPLs (non-performing loans) in total assets. Lending activity in FYR Macedonia grew fastest in the period 2005-2007. In 2009 and 2010, credit activity reduced sharply, contributing to the 2009 recession in the country. During 2011, credit activity in both countries was very moderate.

Figure 1. Percentage change in credit activity and nominal GDP (year on year)

63 The author’s calculations and figures are based on Bank of Albania data (http://www.bankofalbania.org/web/Time_series_22_2.php?evn=agregate_parent_sel&evb=agregate&Cgroups=36&periudha_id=5) and National Bank of FYR Macedonia data (http://www.nbrm.mk/?ItemID=A55FFC32FC478E4A894444507A6C02C45).
Loans grew significantly less, on average, in Bosnia and Herzegovina than in Albania or FYR Macedonia, and less again than in Montenegro in 2006-2008. One reason for this moderate (but still high) increase was the intensity of lending activity in 2002-2005. The loan to GDP ratio in Bosnia and Herzegovina was, at that point, well above those in Albania, FYR Macedonia and Montenegro. Thus, in 2005 the business loans to GDP ratio had been 23.1% in Bosnia and Herzegovina, 15.9% in FYR Macedonia, 13.2% in Montenegro, and 10.2% in Albania. The household loans to GDP ratio was 20.7% in Bosnia and Herzegovina, 7.9% in FYR Macedonia, 5.7% in Montenegro, and 4.7% in Albania.

In 2006 and 2007, Montenegro became the absolute record holder in lending in SEE and the world, however, with an average percentage increase in loans to both enterprises and households of 175% (each year). There was a sharp drop in lending in Montenegro in 2008 (a sharp decline in the growth rate), with an absolute decline following in 2009 and 2010 and continuing into 2011. An enormous credit expansion in the period 2006-2007 caused high rates of economic growth, but was also associated with a huge rise in the current account deficit (from 10% in 2005 to 51% of GDP in 2008). The result was a rapid increase in external indebtedness.

Figure 2. Percentage change in credit activity and nominal GDP (year on year)⁶⁴

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Credit activity measured by the loan-to-GDP ratio (loans to the private sector) reveals a significant difference in the levels of private sector indebtedness—and in changes in indebtedness—among SEE countries in 2008-2010. During that period, the average loan-to-GDP ratio in the region increased from 54.7% to 56.3%. At the end of 2008, four SEE countries had private sector debt that was higher than the average for the region. Private sector indebtedness in Montenegro was 61.8% above the average, compared to 27.6% in Bulgaria, 17.7% in Croatia, and 7.8% in Bosnia and Herzegovina. Two years later (in 2010), private sector debt was highest in Bulgaria and Croatia, at 32.5% and 24.5% above the SEE average, respectively.65

<table>
<thead>
<tr>
<th>Country</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Albania</td>
<td>35.2</td>
<td>36.7</td>
<td>38.0</td>
</tr>
<tr>
<td>Bosnia and Herzegovina</td>
<td>58.9</td>
<td>58.7</td>
<td>56.6</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>69.8</td>
<td>73.3</td>
<td>74.6</td>
</tr>
<tr>
<td>Croatia</td>
<td>64.4</td>
<td>65.9</td>
<td>70.1</td>
</tr>
<tr>
<td>Macedonia, FYR</td>
<td>42.4</td>
<td>43.9</td>
<td>45.6</td>
</tr>
<tr>
<td>Montenegro</td>
<td>88.5</td>
<td>77.7</td>
<td>68.8</td>
</tr>
<tr>
<td>Romania</td>
<td>37.7</td>
<td>39.5</td>
<td>46.1</td>
</tr>
<tr>
<td>Serbia</td>
<td>40.3</td>
<td>45.2</td>
<td>50.6</td>
</tr>
</tbody>
</table>


In 2010, the largest increases in lending (and private sector debt) since 2008 were in Serbia (25.6%) and Romania (22.3%). The only two countries in the region in which credit activity fell during the period 2009-2010 were Montenegro and Bosnia and Herzegovina. In contrast to the enormous credit expansion in 2006-2007, between 2008 and 2010 the decline in credit activity in Montenegro was the sharpest not just in the region but also in all of Central and Eastern Europe. Over the same period (2008-2010), credit activity in Bosnia and Herzegovina decreased by 3.9%.

**Credit activity and growth**

The great importance of credit activity and access to financing for business and investment activity in SEE countries, as in many other regions of the world, is a direct consequence of how transition was carried out, on the one hand, and the structure of financial systems in countries in transition, on the other. In fact, one of the key segments of the transition package based on

the Washington Consensus was a rapid implementation of financial and trade liberalization.  

The liberalization of finance and trade was implemented relatively quickly in SEE countries. It is important to note that in Western Balkan countries, with the exception of Albania, economic reforms were limited or non-existent between 1991 and 1995 (Croatia, Bosnia and Herzegovina, Serbia, Montenegro) or 1999 and 2000 (Serbia and Kosovo) because of war. Measures of financial and trade liberalization were, however, implemented in a relatively short period of time after the end of these wars. Financial liberalization in the region, including full freedom of access by foreign banks to the countries’ financial sectors, was conducted over an average of three years, while trade liberalization, which began in the 1990s, was intensified in 2000-2006.  

The structure of the financial systems in the region was based on the dominant role of commercial banks in financing companies and households. Private sector loans were, in the first decade of this century, by far the most important source of financing for working capital needs and, in part, for the purchase of fixed assets, as well as the dominant source of growth in household purchasing power.

Comparing the data on changes in credit activity and private sector indebtedness between 2010 and 2009 (the year of recession) reveals various factors that influenced the recession. Although Romania saw credit growth of 16.7% over the previous year, it was unable to avoid recession. Romania reduced its current account deficit from 11.2% to 3% of GDP between 2008 and 2010. Romania and Croatia were, however, the only countries in the region that experienced a decline in real GDP between 2009 and 2010 (see Table 13). The Serbian economic recovery in 2010 was partly supported by a growth in private sector loans of 11.9% against the figures of the previous year, and it was followed by a sharp reduction in the current account deficit, from 21.4% to 7.2% of GDP.

The growth of credit activity in Bulgaria in 2010, against that of the previous year, was very modest (1.8%). Yet the country did succeed in almost eliminating its current account deficit. The deficit was reduced from 22.3% to only 1% of GDP (2008-2010). During 2009-2010, the growth of credit activity of 8.9% in Croatia was associated with significant reduction in the current account deficit (from 7% to 1% of GDP). Croatia, however, faced a decline of GDP in both years. The 7.9% increase in credit activity in Albania in 2009-2010 was followed by a reduction in the current account deficit, but not to an extent comparable with the figures for other countries in the region. At the same time, Albania was the only country in the region not facing recession in 2009.

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All SEE countries signed bilateral free trade agreements between December 2000 and October 2003. These bilateral free trade agreements were replaced by a regional free trade agreement signed in December 2006 – the CEFTA (See http://rtais.wto.org/UI/PublicShowMemberRTAIDCard.aspx?rtaid=4).
Chapter 4. Financial constraints on economic growth in South East Europe

Bosnia and Herzegovina and Montenegro were the only two SEE countries to see a decrease in credit activity in 2009-2010. This decrease was associated with a slight increase in real GDP in 2010 (year-on-year) and a sharp decline in the current account deficit in both countries. Bosnia and Herzegovina current account deficit fell from 14.3% in 2008 to 6.5% of GDP in 2010. In the same period, Montenegro succeeded in cutting its current account deficit nearly in half – from an enormous 51% (2008) to 26% of GDP (2010).

Table 6. Current account balance, real GDP growth, and credit growth in SEE countries

<table>
<thead>
<tr>
<th>Country</th>
<th>Current acc. balance % GDP</th>
<th>Real GDP growth</th>
<th>Credit growth (in %)</th>
</tr>
</thead>
<tbody>
<tr>
<td>ALB</td>
<td>-15.6</td>
<td>-15.2</td>
<td>-11.8</td>
</tr>
<tr>
<td>BIH</td>
<td>-14.2</td>
<td>-6.3</td>
<td>-5.6</td>
</tr>
<tr>
<td>BUL</td>
<td>-22.9</td>
<td>-8.8</td>
<td>-1.0</td>
</tr>
<tr>
<td>CRO</td>
<td>-8.6</td>
<td>-5.0</td>
<td>-1.1</td>
</tr>
<tr>
<td>MAC</td>
<td>-12.6</td>
<td>-6.4</td>
<td>-2.8</td>
</tr>
<tr>
<td>MON</td>
<td>-51.3</td>
<td>-30.1</td>
<td>-25.6</td>
</tr>
<tr>
<td>ROM</td>
<td>-11.6</td>
<td>-4.3</td>
<td>-4.3</td>
</tr>
<tr>
<td>SER</td>
<td>-20.9</td>
<td>-6.9</td>
<td>-7.2</td>
</tr>
<tr>
<td>Average</td>
<td>-19.7</td>
<td>-10.4</td>
<td>-7.4</td>
</tr>
</tbody>
</table>

Sources: EBRD, Transition Report 2011; EBRD, Transition Report 2010; the author’s calculations. Note: credit growth in per cent is derived from the level of indebtedness based on data for the loan to GDP ratio for respective countries.

The importance of credit activity for economic growth and investment in most developing and developed countries without arms-length financial systems has been confirmed by several recently published studies. For example, Kalemli-Ozcan, Kamil, and Sanchez-Villegas study the factors influencing the fall in investment in Latin America. The authors conclude that in a period of twin crises, domestic exporters could not finance their businesses due to a lack of access to financing, causing a sharp decline in both exports and economic activity. In their conclusion, the authors point out several important policy implications, including the need to provide liquidity to the banking sector during financial crises so that firms retain access to finance.68

Although this research was done on a sample of companies in Latin America, lack of financial resources due to a fall in lending, especially for export-oriented domestic enterprises, has had a similar direct impact on declining investment activity, the fall or very slow growth of real GDP, and the decline of fiscal capacity in Eastern European countries. The fall in fiscal capacity due to lower business investment, and the consequent decline of wages, salaries, and employment, resulted in an increase in foreign public debt in the countries hit by the crisis. This chain of events has also been confirmed

in SEE countries, and in most of the other transition countries as well. A recent study of the impact of credit activity on investments and economic growth, published by the ECB, demonstrates the key role of banking and credit activity in the business cycle in Eastern European countries (including SEE countries). In a study based on a representative sample of enterprises in the transition countries, the authors found that credit crunches have a particularly harsh impact on export-oriented firms, as these tend to have a higher demand for loans.69

Brown, Ongena, Popov and Yesin also emphasized that there were highly significant differences in the degree of indebtedness and access to loans in Eastern European countries. For example, only 29 per cent of firms in Macedonia have a bank loan, compared with 66 per cent of firms in Croatia. In fact, Croatia is one of four countries in Eastern Europe – the others being Bosnia and Herzegovina, Hungary and Slovenia – where the loan ratio is higher than the Western European average.70

In a working paper published in December 2010, Christian Friedrich, Isabel Schnabel and Jeromin Zettelmeyer examined the impact of financial integration on Emerging Europe’s economic growth.71 They found that the impact of financial integration was highest in the countries politically most integrated with the EU. They also found that the financial integration of Emerging Europe was different from that of other developing regions. The effects of the region’s financial integration on economic growth were above the average in other regions, and, although the growth was associated with a rapid increase in current account deficits, it was not due to falling savings but to investments rising faster than the average. In their paper, the authors point to the importance of financial integration despite the negative effects of the global crisis.72

The main feature of credit activity in SEE for 2004-2008 (the period of fastest growth in credit activity) was that household loans grew faster than corporate ones. The average growth rates for loans to households and loans to companies in Western Balkan countries during this period were: in Albania 59.7% and 50.7%, respectively; in Bosnia and Herzegovina, 26.4% and 23.6%; in Croatia, 18% and 15.2%; in FYR Macedonia, 45.8% and 25.8%; in Montenegro, 106.2% and 85.3%; and in Serbia, 60.8% and 27.5%. Thus, in all the Western Balkan countries, on average, loans to households grew more than corporate loans, in terms of percentage. This percentage change is derived from the amounts of loans approved rather than the change in the level of credit activity shown in Tables 12 and 13, which is expressed as the loan-to-GDP ratio.


This credit expansion, based on faster growth of loans to households than of loans to companies and the breakdown of loans to companies by sector, which was initially dominated by the service sector (trade, real estate and construction), combined to produce a sharp increase in the marginal propensity to import, so that loans approved to households and the service sector contributed to higher trade and current account deficits. Export-oriented companies and projects were not priorities. From 2004 to 2008, almost all the countries in the region doubled their trade and current account deficits.

Since the most important export markets for SEE exporters were Western European (on average about 60% of all SEE exports\(^3\)), the 2009 recession in Western Europe directly caused a sharp decline in trade volume and the incomes of SEE exporters. Decreasing export revenues due to falling demand for SEE goods on Western European markets influenced a decline in domestic demand during 2009, causing wages and employment in export-oriented enterprises to fall.

The chain reaction of tax revenues falling as a result of lower aggregate demand in SEE countries forced Bosnia and Herzegovina, FYR Macedonia, Romania and Serbia to conclude financial arrangements with the IMF. These arrangements contributed to a significant increase in these countries’ external public debt. Conversely, the largest increase in Bulgaria’s external debt was a consequence of economic expansion in 2004-2008 and was primarily due to private debt. In 2008-2010, Bulgaria did not conclude an arrangement with the IMF, as the country was able to reduce imports sharply, increase exports, and almost eliminate the current account deficit. This resulted in a slight reduction of total external debt. During the crisis, Croatia, like Bulgaria, also avoided an agreement with the IMF, but growth in this country fell for two consecutive years. Croatia’s external debt increased sharply in 2008-2010.

### Table 7. The external debt-to-GDP ratio of South East European Countries (% GDP)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Albania</td>
<td>31.8</td>
<td>20.8</td>
<td>20.4</td>
<td>36.6</td>
</tr>
<tr>
<td>Bosnia and Herzegovina</td>
<td>59.2</td>
<td>51.3</td>
<td>42.5</td>
<td>56.9</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>88.6</td>
<td>70.1</td>
<td>103.5</td>
<td>101.6</td>
</tr>
<tr>
<td>Croatia</td>
<td>60.6</td>
<td>70.0</td>
<td>82.4</td>
<td>102.1</td>
</tr>
<tr>
<td>Macedonia, FYR</td>
<td>41.5</td>
<td>52.4</td>
<td>49.1</td>
<td>59.0</td>
</tr>
<tr>
<td>Montenegro</td>
<td>---</td>
<td>23.6</td>
<td>52.7</td>
<td>100.2</td>
</tr>
<tr>
<td>Romania</td>
<td>27.7</td>
<td>39.3</td>
<td>42.2</td>
<td>76.4</td>
</tr>
<tr>
<td>Serbia</td>
<td>105.0</td>
<td>59.8</td>
<td>60.4</td>
<td>83.1</td>
</tr>
</tbody>
</table>


\(^3\) Data on the geographical distribution of trade can be found at the WTO web site: http://rtais.wto.org/UI/PublicSearchByMemberResult.aspx?MemberCode=070&lang=1&redirect=1
The data in table 7 show very different rates of change in the external indebtedness of SEE countries. Montenegro’s external indebtedness has sharply increased. Extremely high rates of credit growth during 2006 and 2007 were directly related to the growth of external debt based on credit lines from abroad, which were the primary source of funding for economic growth. There is only a small number of export-oriented companies in Montenegro, and the country was unable to increase exports in the aftermath of the crisis.

Table 8. Percentage change of the level of indebtedness of SEE Countries (in %)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Albania</td>
<td>-1.9</td>
<td>+ 79.4</td>
<td>+ 76.0</td>
</tr>
<tr>
<td>Bosnia and Herzegovina</td>
<td>-17.2</td>
<td>+ 33.9</td>
<td>+ 10.9</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>+ 47.6</td>
<td>-1.8</td>
<td>+ 44.9</td>
</tr>
<tr>
<td>Croatia</td>
<td>+ 17.7</td>
<td>+ 23.9</td>
<td>+ 45.9</td>
</tr>
<tr>
<td>Macedonia, FYR</td>
<td>-6.3</td>
<td>+ 20.2</td>
<td>+ 12.6</td>
</tr>
<tr>
<td>Montenegro</td>
<td>+ 123.3</td>
<td>+ 90.1</td>
<td>+ 324.6</td>
</tr>
<tr>
<td>Romania</td>
<td>+ 7.4</td>
<td>+ 81.0</td>
<td>+ 94.4</td>
</tr>
<tr>
<td>Serbia</td>
<td>+ 1.0</td>
<td>+ 37.6</td>
<td>+ 39.0</td>
</tr>
</tbody>
</table>


Romania and Serbia have emerged as the countries with the highest burden of debt to the IMF in the region. In March 2009, Romania signed a SBA with the IMF. The total amount approved was SDR11.44 billion, of which Romania has drawn SDR10.57 billion (1,026% of its quota with the IMF). In January 2009, Serbia also signed a SBA with the IMF. The total amount approved was SDR2.62 billion (292% of the country’s quota with the IMF) of which Serbia has drawn SDR1.37 billion. The highest burden of debt repayment comes due in 2013 and 2014. Bosnia and Herzegovina is the third largest debtor in the SEE to the IMF. The country signed a SBA with the IMF in July 2009. The total amount approved was SDR1.02 billion of which the country has drawn SDR338 million.

Table 9. Projected payments to the IMF based on existing use of resources and present holdings of SDRs

- millions of SDR

<table>
<thead>
<tr>
<th>Country</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Romania</td>
<td>1,592</td>
<td>4,295</td>
<td>3,950</td>
<td>1,242</td>
</tr>
<tr>
<td>Serbia</td>
<td>191</td>
<td>580</td>
<td>502</td>
<td>117</td>
</tr>
<tr>
<td>Bosnia and Herzegovina</td>
<td>27</td>
<td>140</td>
<td>248</td>
<td>33</td>
</tr>
</tbody>
</table>


Kosovo is the youngest member of the IMF from the region (it became a member in June 2009). In July 2010, Kosovo signed an SBA with the IMF. The total amount approved was SDR 92.7 million and the amount drawn by the end of 2011 was SDR 18.8 million.\textsuperscript{77} FYR Macedonia signed a PCL (Precautionary Credit Line) with the IMF in January 2011. The total amount approved was SDR 413.4 million and the amount drawn by the end of 2011 was SDR 197 million.\textsuperscript{78}

Rapid expansion of international banking activity and growth of international capital flows from 2000 to 2008 had a direct impact on the credit activity of banks in SEE countries.\textsuperscript{79} Relatively high growth in FDI in the region was a direct consequence of the rapid increase in international capital flows during the same period. In the first decade of this century, the largest FDI per capita in SEE was in Bulgaria and Croatia ($5,960 and $5,000, respectively).\textsuperscript{80} The third largest recipient of FDI per capita in the region was Romania. The highest inflow of FDI was secured in the period 2004-2008, corresponding to the high rates of economic growth associated with rapidly growing external debt. This situation especially characterised Bulgaria, which increased its level of external indebtedness over the same period by 47.6%.

\begin{table}
\centering
\caption{Foreign Direct Investment in SEE} \label{table:fdi}
\begin{tabular}{cccccccc}
\hline
Year & ALB & BIH & BUL & CRO & FYM & ROM & SER \\
\hline
2000 & 143 & 150 & 998 & 1,085 & 176 & 1,051 & 25  \\
2001 & 204 & 130 & 803 & 1,407 & 439 & 1,154 & 165  \\
2002 & 135 & 266 & 876 & 591 & 77 & 1,080 & 475  \\
2003 & 178 & 382 & 2,070 & 1,927 & 118 & 2,156 & 1,365  \\
2004 & 324 & 708 & 2,879 & 732 & 322 & 6,368 & 966  \\
2005 & 258 & 608 & 4,005 & 1,551 & 95 & 6,587 & 1,550  \\
2006 & 315 & 718 & 7,583 & 3,194 & 424 & 10,957 & 4,264  \\
2007 & 647 & 2,087 & 11,433 & 4,736 & 700 & 9,629 & 2,523  \\
2008 & 874 & 908 & 9,187 & 4,706 & 601 & 13,606 & 2,714  \\
2009 & 924 & 245 & 3,525 & 1,617 & 186 & 4,934 & 1,881  \\
2010 & 1,098 & 199 & 1,936 & 452 & 292 & 3,583 & 1,141  \\
\hline
Total & 5,100 & 6,401 & 45,295 & 21,998 & 3,430 & 61,105 & 17,069  \\
\hline
USD per capita & 1,594 & 1,684 & 5,960 & 5,000 & 1,715 & 2,740 & 2,276  \\
\hline
\end{tabular}
\textsuperscript{*millions of USD}
\end{table}


\textsuperscript{80} Based on data published in the EBRD Transition reports for 2005, 2009 and 2011.
In both Bulgaria and Croatia, there was a strong correlation of rapid growth in FDI with growth in external debt (as a result of the growth in private external debt) between 200 and 2008. Such trends can be explained by the structure of FDI. In both countries, the overall structure of FDI was dominated by investments in finance, real estate and trade. Out of the total FDI in Bulgaria, the largest shares went to real estate (21.7%) and finance (19.1%). The combined share of FDI represented by real estate, finance and trade in Bulgaria was 57.5%, whereas manufacturing represented only 18.3%. The structure of FDI in Croatia was similar. Most FDI went to finance (34.2%). The combined share of finance, trade, telecommunications, and real estate was 57.5%.

**Portfolio theory and the opportunities for capital market development**

Representatives of the SEE countries met at the Regional Cooperation Council in Sarajevo and signed the Memorandum of Understanding on 27 March 2012. The aim of signing this document was the formation of a single electronic platform for the development of capital markets in SEE countries. The capital markets of South East Europe, especially the Western Balkan countries, are too atomized. The administrative barriers hindering economies of scale in financial markets are the most serious obstacles to lowering transaction costs and to successfully structuring portfolios.

Starting from the fundamentals of portfolio theory as founded by Harry Markowitz and of capital market theory as developed by Sharpe, Lintner and Treynor, the structuring of a successful financial portfolio is based on the dispersion of risk, for which the existence of risk-free (or at least less risky) securities is a precondition. The possibility of structuring a portfolio of financial institutions and investors in capital markets that are atomized and where no risk-free (or very low risk) securities exist is very limited. In other words, capital markets characterized by the predominance of risky financial securities mean financial investors cannot structure their portfolios successfully. Such financial markets operate on a sub-optimal level, in comparison with financial markets based on a sufficient range of financial assets – from risk-free to risky financial assets. In such circumstances, financial investors cannot achieve the target level of return with a minimum of risk, compared to financial markets where financial assets are on offer over a wide range, starting from risk-free securities (bonds of countries with high ratings).

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the bonds of international institutions and financial agencies) and ending with high risk securities (shares of companies with highly uncertain profit potential).

The EBRD’s 2010 Transition Report’s third chapter emphasized the need to develop a financial market based on financial assets denominated in domestic currencies in the countries of South East Europe (and in other transition countries) as an important element in reducing the tendency of banks to borrow in foreign currencies.\(^8^4\) The Report also particularly emphasized the very important role of institutional investors in the development of capital markets in domestic currencies.

Returning again to the basis of the theory of capital markets and to the valuation of financial assets, where the risk-free rate is one of the fundamental elements in financial assets pricing, the main question that arises is how to enable the development of domestic capital markets in SEE countries without risk-free financial instruments. In fact, government bonds in all the SEE countries (with the exception of Bosnia and Herzegovina, where there are none on the domestic capital market) are basically risky financial assets, as the countries’ ratings are low or relatively low. The fact that assets denominated in local currencies in SEE tend to be high risk has meant that institutional investors reduce their portfolio risk by holding a significant proportion of their assets in foreign securities (Western European countries’ bonds), with a concomitant outflow of financial capital.

One possibility that could contribute to successful structuring of the commercial banks and institutional investors’ portfolios in SEE capital markets has been recently proposed in two papers.\(^8^5\) The idea is based on issuing government bonds of the Western Balkans (SEE countries) denominated in domestic currencies, but guaranteed by an EU Guarantee Fund for the Western Balkans. These are named Euro Balkan Bonds. Proceeds from the sale of these financial assets, with maturities of 10 to 15 years, would be used exclusively for funding the development of cross-border projects. The EU Guarantee Fund would have the right to review public finances every six months in SEE countries issuing such bonds, with a guarantee-to-equity option (as compensation for bearing the guarantee risk). In other words, the Fund would be given the right to convert the guarantee into common stocks of the public utilities controlled by the governments in the region.

Issuing such bonds on the domestic capital markets of SEE would broaden and deepen the regional financial markets, based on the emergence of risk-free financial instruments with low interest rates. These financial instruments denominated in the national currencies of the Western Balkan and other SEE


countries would provide the basis for much more successful structuring of institutional investors’ portfolios in SEE domestic capital markets, while linking the economies of the region and supporting economic growth on a more sustainable basis.

Concluding remarks

An analysis of the main factors impeding investment and sustainable growth suggests that institutional weaknesses – inefficient bureaucracy and unstable and corrupt institutions – were the predominant barriers to business growth in the pre-crisis period. Nonetheless, all the SEE countries did achieve relatively high rates of economic growth at that time. These growth rates were based on the large credit expansion generated by the presence of banks from the EU that improved the technology of financial operations and contributed to easier access to financing from Western Europe.

Since the crisis, access to financing, tax rates and tax systems have emerged as major obstacles. A sharp decline in credit activity in the region has directly affected household consumption and business investment. In the business sector, export-oriented companies were among the most affected. Economic growth throughout the region has been based on domestic demand-led growth. There is a lack of clearly defined strategies to attract export-oriented FDI. There is also a lack of well-established and sufficiently capitalized financial institutions responsible for financing export-oriented companies and projects. Such institutions could be crucial to a shift from domestic demand-led to export-led growth in SEE countries.

In this sense, SEE countries should redefine their strategies to attract foreign direct investors and provide significant tax relief for investors with a long-term export-orientation who can also integrate local businesses into international production chains. Another important conclusion from this paper is that SEE countries should establish stronger financial institutions to finance export-oriented projects. These two measures, combined with tax incentives for domestic investors with export potential, can contribute to a change in the dominant development model that has been practiced in SEE countries for the past two decades.

The development of domestic capital markets in SEE countries, and especially in the Western Balkans, is critically dependent on a supply of new and less risky financial instruments that can finance economic growth based on capital projects. For the SEE countries to offer the new types of risk-free or minimum risk financial instruments needed to restructure domestic financial institutions’ portfolios, they must have the support of EU guarantee schemes. In that sense, the idea is to issue new types of government bonds backed by EU guarantee schemes that would allow better and more efficient portfolio management of domestic financial institutions, while supporting economic growth and linking economies in SEE.
Chapter 4. Financial constraints on economic growth in South East Europe

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Defining a New Reform Agenda  Paths to Sustainable Convergence in South East Europe


Introduction

The Balkan countries occupy a very specific location in European space and time. Geographically, the region belongs to Europe; however, it is not part of Europe politically or administratively. Its countries function in the 21st century, but are neither at the same stage of development as their European neighbours, nor as wealthy as them. Despite emerging and beginning to develop in the early stages of European civilization, the region has been lagging in terms of social, political and economic development ever since the Roman Empire split, witnessing the region become part of the Byzantine Empire. This development shifted the Balkan region from the centre to the margins of the great powers of the time – a position in which it has remained ever since. Currently the Balkans, or South East Europe (SEE), is the last region to complete the EU integration process, not only politically but also economically. This situation is rooted in the disintegration process of the early 1990’s, even though that process gave birth to new nations that enjoyed political, economic and social prosperity throughout much of the past decade.

Over the last 20 years, the region has been characterised by two trends whose interaction over time has been extremely complex. The first trend is political development: the process of disintegration in search of independence as stand-alone democratic states. The disintegration of Yugoslavia into individual, stand-alone nations was particularly difficult, leading to several very violent ethnic, socio-political conflicts in the region. At the end of this process, all the countries involved refocused their policies toward the process of European integration, seeking political, economic and social integration with the European Union (EU). The second trend is economic development, embodied in the set of economic reforms undertaken to transform these transition economies into emerging market economies. These trends have proceeded at different speeds in the region, amidst contexts of war, political turmoil, ethnic conflicts, slow structural reform, corruption, and a slow democratization
process. This experience left a distinctive and problematic situation that still haunts the region, and prevents it from attaining the prosperity it deserves on the merits of its generous natural and human endowments.

Since 2000, both the region and the EU have accepted the role of the latter as a political, economic and social anchor. The reward for enduring this painful transformation process is the promise of EU membership, with all its benefits. The motivation derives from the conventional wisdom that EU integration will transform SEE institutionally and economically, thus enabling it to gain a similar level of economic prosperity and political freedom as the rest of developed Europe. In principle, this transformation was to shape the development model of all Central and Eastern Europe (CEE), as these countries succeeded in increasing their standards of life and becoming part of the EU politically and, in a gradual way, economically.

Currently, due to the EU Accession process and its anchoring role, the region looks closer than ever to achieving prosperity, and to welcoming foreign direct investors, with their financial resources and expertise. However, at this particular moment, the EU – the very anchor and model for the region – finds itself in the midst of an economic, financial and sovereign debt crisis and the engendered political tensions. As a consequence, the EU is less than ever prepared to play its anchoring role, and this reality entails potential implications for developments in the region.

Against the backdrop of this crisis, SEE is seeking to position itself as the last ‘land of opportunity’ in Europe – both in terms of business opportunities and comparative advantages sought by foreign capital – so as to repeat the economic miracle of its CEE peers. This paper examines the stage of development of the region to evaluate whether it is ready to do so.

In general, the SEE region has been growing rapidly over the last two decades, based on factor redistribution and strong financial intermediation. However, it has not been as successful as its CEE peers in raising the living standards of its inhabitants. Income per capita has increased, but by less than that of the CEE countries that are now members of the EU. By comparison, countries in SEE have not been as successful at establishing successful agricultural or industrial sectors, and their manufactured exports comprised mainly finished products in the category of textiles and footwear.

The history of transition also shows that economic development goes hand-in-hand with the political integration process. There is no doubt that the successful integration of CEE countries in the EU is a major explanatory factor of their success. This relationship is attributed to the positive impact of integration for market reforms and institution-building, as well as to the economic benefits of the single market. However, it is the scale of foreign direct investment, the nature of foreign capital, and the accompanying technological advancements, that represent by far the biggest differences between CEE and SEE in terms of trajectories of development.86

86 See Kinoshita (2011) and Landesmann (2010) for a detailed analysis of investment manufacturing and export trends in CEE and SEE.
Policymakers in the SEE region are conscious of the role that foreign direct investment (FDI) plays as an important determinant of growth. The region anticipated during the last 10 to 15 years (for some countries, even 20 years) receiving FDI flows on a scale comparable in size and nature with those directed to CEE, but without major success. This dilemma has defined SEE’s catching-up process. The inability of the SEE region to accomplish the same miracle as the CEE reflects the slow pace of progress in several areas: the political process of integration, the implementation of economic, social and institutional reforms, and the role of state institutions. These developments are useful in explaining patterns of FDI and of economic development. However, several other demographic, geographical and microeconomic factors carry important explanatory power with regard to the limited success of SEE countries in attracting foreign direct investment.

In principle, this paper investigates the characteristics of SEE and the particular determinants of FDI in this region, and then compares these to comparable features in CEE and in BRIC countries. The differences are used to evaluate potential problems, and thus to help identify the scope for reform in SEE. These determinants are grouped in two particular categories: the first concerns macroeconomic and institutional issues related to macro financial stability and institutional capacity; and the second draws together micro-founded elements such as endowments, their particular characteristics, and the ability of SEE economies to foster their exploitation in light of comparative advantage, as seen by foreign companies in a global perspective.

Our analysis is based on existing working and policy papers, and benefits from the fact that the region has been the subject of significant research that focuses on the economic development of SEE – in its own right, as well as in the context of CESEE. We review this literature and use it in our analysis from the two different points of view mentioned above.

From both standpoints, the region’s progress is strongly affected by the speed of the EU integration process and by economic developments in Europe. In fact, the region has relied heavily on the EU market for its trade and investments. However, in the current state of affairs, the speed of progress will strongly depend upon developments at a global level rather than in the bilateral relationship between the region and the EU. Therefore, solutions must be identified in light of the global economy rather than solely in terms of the EU. This, we believe, is the best approach to developing a strategy and suggesting the appropriate reform agenda for the SEE region.

As such, the probability of success in the SEE region will depend on its ability to repeat the accomplishments of the CEE economies, and speed up these trends by becoming relevant to EU and other global investors simultaneously. Our analysis leads toward the conclusion that - due to specific regional, EU and global factors – the region faces difficulties in the fulfilment of this goal, and needs to speed up reforms in several areas.

In general, from an economic point of view, we conclude that the region must increase its scientific output (publications and patenting), accelerate the
commercialization of research, and promote private R&D. Meanwhile, on the political, institution-building and reform agenda, the countries of the region must seek to reduce the cost of reform by avoiding duplication and increase regional cohesion in the research, education and marketing of regional opportunities.

SEE as a unique story: the fundamentals

In principal, economists believe they have reached a reasonable understanding of economic growth and its determinants, both in theory and in practice. According to economic wisdom, economic growth is simpler for the relatively few economies that are lavishly rich in scarce resources of production, because they base their prosperity on such endowments and their exploitation. The rest try to make the most of their resources by increasing productivity, reducing costs of production, and engaging in the free trade of goods, services and capital. Both models rely on efficiency improvements afforded by technological process and efficient markets, which price opportunities and facilitate the exploitation and mix of factors of production. The most important conclusion is that there is no limit to economic growth as long as countries undertake the correct reforms. That is not much to say though, as the term “reforms” is relatively general without specifically indicating the nature of reforms (measures and their sequencing) in practice. Moreover, “reforms” are not unique and depend on the particular set of characteristics and stage of development that prevails in a particular period of time.

Theory also predicts that in the absence of trade restrictions, and other financial and governmentally imposed barriers, whether the abundant factor is gold or cheap labour, markets will let the capital flow to exploit it. If not, then there will simply be no demand for the factor that must upgrade to enhance its status and to make it useful to existing technologies. Therefore, the scope and direction of reforms must focus on pursuing policies that, firstly, increase and improve the efficiency and/or reduce the cost of the endowed factors of production; and, secondly, improve the functioning of market mechanisms or remove the obstacles and barriers that prevent the free movement of such factors. All these changes will attract the interest of foreign capital to exploit existing resources and foster economic growth. This logic pits relatively equally endowed economies against each other in a fight to fulfil all reforms that make their national resources relatively more accessible, relatively less expensive, or relatively more productive than those of their competitors. Last, but not least, is the ability of domestic factors to yield a stable economic and political environment that will allow capital to grow in a protected and predictable way.

From this point of view, the scope and the role of reform are crucial not only in achieving but also in preserving comparative advantages in an evolving global economy. Any advantage gained either in productivity or in market efficiency is relative, as the rest of the world will constantly try to do the same at a faster speed.
The SEE region has made extensive use of this knowledge to change and adapt its economies by liberalizing prices and transactions, opening its markets, building institutions, and achieving a respectable degree of macro financial stability. In this way, its countries have succeeded in achieving impressive economic growth during the last 10 years. The economies of the region belong in the group of transition economies in Central Eastern and South East Europe (CESEE) and this reform was focused on transforming them into market-oriented economies. This process saw these capital-scarce, labour-abundant, and consumption-starved economies transform themselves into attractive markets for foreign direct investment, which brought in foreign capital, technology and entrepreneurship.

The growth model of the transition – or, as it is also known, the growth model of CESEE – is only 20 years old, but it is well understood for two main reasons. First, from the practitioners’ (politicians’ and decision-makers’) point of view, economic growth did not just “happen”, but followed a well-designed path embodied in specific political, economic and social processes, based on the Washington consensus and built upon IMF-supported programs and the EU integration process. Second, understanding of this process is equally contingent upon a significant amount of research conducted on the topic by academics. Both these assertions, those of practitioners and academics, conclude that the EU is the real engine of growth in the CESEE region.

This research suggests that transition economies have experienced three similar main trends of growth. First, early in the transition period, they benefitted from internal market opportunities unleashed by structural, market-oriented reforms and based on factor redistribution. Second, they benefitted from considerable foreign direct investment. Third, and more recently, capital flows took the shape of inflows of foreign financial capital into financial systems to develop an absorption-led growth model, fuelling large trade and current account deficits. This last model vanished with the outbreak of the financial crisis in the autumn of 2008, slowing their successful and sustainable catching-up process from that moment on. The particular characteristic of all transition economies was that the source of FDI, as well as its main trade partner in goods and services, was mainly the European Union, whose economic developments and/or financial and economic problems define, in general, the trends of growth in CESEE.

The timing, size, nature and geography of FDI are very different in the two regions that comprise CESEE. Compared to the CEE countries, FDI flows in SEE countries were smaller in size, came mostly from the slower Southern EU-15 countries, and went mostly to non-tradable sectors. Both domestic and foreign factors are to blame, yet it is important to emphasize that following the fall of the Berlin Wall, the SEE region lost precious time due to political, ethnic and national conflicts that restrained investors despite perceived

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87 See European Commission (2009), Atoyan (2010) and Böwer and Turrini (2009), among others, for material on this topic.
economic motives to invest in the region. In the meantime, foreign (EU)
capital in CEE linked its industries with developed Europe and speeded the
transfer of technology and human capital development. Typically, the EU
integration process, the nature and origin of investments, and the speed of
income growth, employment and economic development are endogenous to
one another.

In general, SEE has failed to become a relevant partner for the EU. As a
matter of fact, the region has almost been a burden for the EU, considering
its conflicts, uneasy politics, corruption and social problems (the biggest one
being emigration). Therefore, the relationship between the EU and the region
resembled more a costly transfer rather than a beneficial exchange.

Minchev (2010), in his analysis of the region, avers that the countries of SEE
have yet to complete the post-communist transition in terms of establishing
and consolidating functional democratic institutions. The region has not fully
recovered from recent ethnic conflicts and has not completed the process of
political, social and economic modernization. ‘Balkanization is – in effect –
a long term crisis of modernization’, concludes Minchev (2010). Change is
particularly difficult in SEE because it requires a regional agreement among
different groups of interests. The society of SEE is a product of a long history
of conflicts and other social interactions, which have settled in three pertinent
cleavages along the fault lines of ethnicity and religion, nation-states, and
ideological (including economic interests) characteristics. These cleavages
overlap to form a particularly tense and fragile social fabric. In this respect,
the SEE region has not been able to realistically view itself and its abilities
as a potential partner mutually benefitting both parties (the region and
investors). Until now, this social fabric has been held together by simultaneous
interventions of regional political leaders, as well as changes brought about
through the EU integration process.

Currently, the economic situation in SEE is relatively strong and financially
solid. Inflation seems to be well controlled, and economic activity allows for
optimism. Public finances are healthier – in terms of fiscal balances and debt-
to-GDP ratios – than in developed Europe. Financial and macroeconomic
stability, judged by conventional indicators, is overall stronger than in some
of the struggling EU members. Most importantly, the countries of the region
have retained their sovereign risk rating throughout this period.

Yet, these developments represent a bittersweet victory. A less encouraging
view reflects the fact that it is those struggling EU economies that fuelled
growth in the region in the first place, through trade and direct investment.
The Eurozone crisis will negatively affect the economic and financial stability
of the region – with shrinking remittances, trade exchanges, capital transfers,
aid and projects, not to mention the psychological impact of the crisis.

The origin of FDI flows, especially in the financial sector, carries over the
problems and the stigma of the mother companies (mainly Greek and Italian
banks) into the region’s financial system, and it could impose financial
constraints on SEE’s governments and economies. In the same fashion, equally
The EU economy currently faces wide problems in terms of macro financial stability. Connections are often made between, on the one hand, lower economic activity, rising unemployment and stagnant wages, and on the other, between the EU Enlargement process, in particular, and globalization, in general. This view has started to gain ground among academics as well. Prolonged capital and liquidity problems in the financial sector that relate to sovereign debt and to the fiscal position of several Eurozone members are consuming most of the intellectual, economic and political resources of EU policymakers. Therefore, a slight potential risk exists that the support for EU integration may diminish with time, as the traditional partners try to resolve their economic and political problems.

The presence of the above-mentioned problems increases uncertainty and the cost of capital. Such problems deter foreign direct investors, and they make SEE less attractive than comparably endowed regions, not only in the European market, but also globally. The presence of an effective EU anchor, in conclusion, is a key factor that increases the chances for SEE to converge in a single economic area within a supranational Europe.

The above analysis is, in fact, very close to the business perception of the region. Two particular business surveys, Attracting FDI in SEE (2011) and The Global Competitiveness Report 2010-2011, find that, from the business point of view, the countries of the SEE region are not very different from one another, as indicated by the nature of the obstacles and problems that foreign direct investors face. When asked to identify the most problematic obstacles they find when doing business in the region’s countries businesses identify in the first top five places of the list more or less the same set of problems. These issues include: political instability, inefficient government bureaucracy, taxes and tax regulations and corruption (inadequate infrastructure is less pronounced in terms of identified obstacles to business). In general, they reaffirm that all problems mentioned above relate to the role of institutions as an obstacle to investment and growth, and as factors raising the financial costs of investment.

Surprisingly, one item that makes the list of complaints for every single country in the region is “Access to Finance”. On the surface, this assertion starkly contrasts the overall view that financial intermediation has progressed very rapidly in the SEE region. Today’s inability to finance new business plans

88 See Rodik (2011) and Spence (2011).
relates to a shortage of credit that mirrors the financial troubles in the post-crisis economy, but also highlights an important factor which relates to the nature and shape of the financial system. In the countries of SEE, financial systems are almost completely identified with the banking system. They lack important market segments, such as pension and investment funds or specialized development finance institutions. Without this complete infrastructure, financial systems face a paralysis in terms of financing opportunities, as commercial banks have to stretch the term structure of their assets and liabilities in very different time horizons, increasing the risks that arise from a mismatched structure of the balance sheet. Institutional reform must seek to expand the market with all its traditional segments.

It is frequently advised that the region needs a new model of growth. However, surprisingly, in Albania this is frequently perceived as a request for the authorities to select and support the group of industries that should receive most economic and political support. This narrow view marginalizes the role of the government and institutions in the identification and elimination of all potential obstacles to free trade and development of resources in SEE. Therefore, the new model needs to analyse the region’s micro foundations from a global viewpoint.

Taking stock of the current situation and cooperation efforts: the micro analysis

Time and again, countries of the region have perceived and advertised themselves as good investment opportunities, full of comparative advantages – appealing to foreign investors as a next land of opportunity. Despite these attempts, however, they have been less than successful in gaining the attention of financial markets. The value, nature, geographical distribution, and the contribution of foreign direct investment flows have been inferior to those in the CEE countries and in other currently successful developing regions of the world. The SEE’s failure to identify its comparative advantages, and to introduce these advantages to actors in the global economy, is probably one important factor in terms of this poor performance.

The business view of the region

It is a fact that SEE represents a relatively well-endowed region – rich in natural resources, such as minerals and fresh water, and featuring younger populations compared to its EU partners. The region is positioned as a gateway to Europe and is beautifully located in the Mediterranean. Moreover, it is rich in history, culture and ethnography, which date back to the earliest European civilizations. This makes the region attractive for tourism and a natural gateway to Europe. Businesses acknowledge and accept this view of the region, and its potential for economic profit and growth. The results

89 See Fullani (2011), speech in Fieri.
90 See Fullani (2012) and Anastasakins and Watson (2011)
of the survey *Attracting FDI in SEE* (2011) show that the majority of foreign direct investors are encouraged by the region’s performance, with about half of them planning to reinvest, and about a third of investors outside the region planning to invest in SEE – citing low labour costs and flexible labour policies, as the regions’ key comparative advantages. Tanku (2012) shows that these characteristics have awakened the interest of the global economy, drawing the attention of the fast growing countries, in particular Russia and China. These facts demonstrate the potential interest in the region.

This interest and the resources that have motivated it, however, do not translate automatically into comparative advantages. To complete the comparative advantages evaluation, the analysis must consider the particular issues of resource productivity and the ease of exploitation, distribution and tradability. These foundations of microanalysis play an important role in private decision-making and can probably explain the reticent attitude of private capital, and the outcome of foreign direct investment in SEE.

There are several sources that discuss the SEE region and analyse its comparative advantages from a business viewpoint. Generally, these studies conclude that despite cheap labour and a beautiful coastline, rich soil, and other factors, SEE lacks particular elements that could materialize its abundant resources into comparative advantages.

### Market size

Globalization of the world economy in the last 20 years has changed the scope and notion of comparative advantage for SEE’s economies. Currently, SEE does not only compete with the economies of EU or CEE, but also competes with the emerging economies of Asia, Latin America, Russia, Africa, etc. When compared to the successful economies of CEE, or the BRICs, the economies of SEE are rather small in terms of space, demographics, and products. Different from the economies of SEE, BRIC and CEE represent large markets for factors and final products that can be easily accessed, with considerable impact on business and profits. The small open economies of the SEE region do not offer sufficient economies of scale. *The Global Competitiveness Report* 2010-2011 shows that countries of the SEE score particularly low in the market size competitiveness indicator. They have a score that ranges between 3.6 (the highest), for Croatia and Serbia, to 2.8 (the lowest), for Albania and Macedonia. Their global position is well below average in both domestic and foreign market size, pointing to a significant disadvantage.

It is probably due to this reason that analyses of economic and institutional reforms by international organizations consider the region as a single economic area. This larger economic area treatment is evident in the design and implementation of several political and institutional initiatives. The involvement of the international institutional, political and economic community in the region takes the form of regional working groups focused on regional goals. The likes of the Stability Pact, the Central European Free Trade Agreement, the OECD’s Investment Compact for South East Europe,
the Regional Council Cooperation and the EU in particular aspects of integration have designed, adopted and coordinated their policies around regional development projects. They encouraged regional cohesion in strategic priorities, policies, and structural reforms, pressing (or imposing) their agenda in regional round tables with consulting, planning and coordination institutions, as well as policymakers and executives from the region’s countries.

Similarly, EU financial institutions, represented by EU banks or financial initiatives like the European Fund for South-East Europe, or the Vienna Initiative, have followed a regional approach, with almost the same institutions being present in the region rather than being specifically located in individual countries. The scope of such business organizations is to transform the entire region into a single economic area: a single market with compatible business rules, legislation and procedures, interrelated infrastructure, compatible education systems and human capital, common energy and environmental strategies and interrelated physical and energy infrastructure.

The region has made considerable progress in these directions. However, despite international and regional actors’ efforts to foster regional cooperation through the creation of a single regional market based on cooperation in the area of investment-related issues (OECD Conference Paris 2011), the region remains a group of small individual economies, distinguished by specificities and idiosyncrasies. The World Bank’s *Doing Business Report* (2012), the EBRD’s *Transition Report* (2011) and the European Commission (2011) measure and identify these differences in the form of individual or aggregate indexes or country specific rankings.

One of the most frequently used examples of these differences is the comparison of the number of days needed to open a business. Setting up and operating a business is a task that varies widely across the region depending on the country in which the business operates. Individual Doing Business indicators (overall score) place the region’s economies in very different positions, from 23 (occupied by FYROM) to 126 (in the case of Bosnia Herzegovina), with the rest of the countries evenly distributed in between. These differences manifest themselves in the areas of liberalization and privatization, competition, exchange rate regime, infrastructure and environmental protection. In this view, the region does not portray itself as a single economic area for foreign direct investment. Instead, such differences impose large costs on regional projects and encourage business fragmentation. Such fragmentation reflects not only the speed of reform, but also the mentality of competition. Outside regional activities, individual countries are presenting and emphasizing individual development plans and emphasizing comparative advantages on national, rather than regional, levels. This discouraging reality is completely at odds with foreign investors’ preference for a single regional market based on cooperation in terms of investment-related issues (OECD 2011).
Clusters and concentration

In profit-maximizing microanalysis, size is also related to efficiencies derived from economies of scale, which means that demographics and size matter for business and investment in terms of efficiency and cost reduction. Both these factors benefit from large numbers and from the exploitation of economies of scale, as well as economic clusters.

The OECD has studied the production and manufacturing structure of SEE. This research finds that the region enjoys advantages in the low-tech manufacturing of final goods and low-to-medium-tech manufacturing of intermediary products. However, these advantages in manufacturing are unevenly distributed: the top ten regions that produce 40 per cent of total manufacturing are located unevenly in SEE, and comprise a variety of industries rather than region-wide ones. “Food and beverages” is the leading industry in the region, and, in general, manufacturing is heavily concentrated in low- and medium-tech industries.

The geographical structure of industrial production in the SEE region is highly concentrated; most manufacturing activity is concentrated in Serbia and Croatia (the OECD analysis includes Croatia in SEE). Boc and Lanz (2011) estimate that the top ten regions, out of 102 total regions in SEE, account for 40 per cent of total manufacturing activity. Unfortunately, this high concentration is explained by within-country concentration rather than between-countries concentration. This pattern of location concentration is higher for low-tech industries. The nature of this concentration has prevented the creation of regional clusters, better factor redistribution, and value chains across the region. The characteristics of regional supply chains confirm the same results. Specific country locations in supply chains show that the region’s countries enjoy comparative advantages in the same industries. These prevailing characteristics of industrial production, combined with the geographical structure of manufacturing in the region, increase and exacerbate regional competition, rather than fostering regional specialization and cooperation.

Overall, the current structure of industry location and supply chains undermines various regional and international efforts to achieve regional economic cohesion and regional cooperation in terms of creating a single economic area for trade, strategic policy coordination, and joint efforts to attract large-scale foreign direct investment. It is one of the reasons behind regional trade exchanges that fail to meet their potential. Recent empirical research and analysis at the Bank of Albania on regional trade supports these conclusions.

Fullani (2012) discusses the theme of regional cooperation and integration by developing and analysing two particular trade indicators, “trade complementarity indexes” and “trade readiness indicators”, for the South East Europe region. Fullani finds that countries are more or less similar in terms of trade patterns and economic structures, as measured by trade complementarity indexes, because they have similar economic structures and trade patterns. Trade complementarity indices are relatively high for the
larger economies of Croatia and Serbia and lower for Albania, FYROM and Bosnia Herzegovina, complementing the concentration analysis of Boc and Lanz (2011).

Based on the trade readiness indicators, Fullani (2012) concludes that suboptimal regional cooperation is likely caused by politically rooted factors; therefore, reforms related to further deregulation and privatization will likely improve cooperation, increase the mobility of factors of production, and provide scope for economies of scale. This conclusion is also supported by his observation that CEFTA ratification has substantially increased Trade Complementarity Indexes for Albania. Pllaha (2012) confirms the same result – his empirical analysis of SEE regional trade based on gravity models shows that free trade agreements in the region positively impact regional trade for the region’s countries.\(^91\) He also finds that that regional trade exchanges are influenced by distance and a colonial dummy (as a measure of common culture and history, past or existing trade networks). Additionally, common borders play an important role in terms of trade flows and pat exchanges in the SEE region. However, the most important and significant conclusion based on such models is that the current level of intra-regional foreign trade is way below its potential. On the other hand, trade with EU partners remains at optimum levels.\(^92\)

**Infrastructure development and trade integration**

It is important to note that analysis based on gravity models of trade (Pllaha, 2012) indicates that current patterns of concentration and trade integration are also affected by distance, which acts as an indirect measure of the effect of infrastructure on trade. Monastiros (2009) derives a similar conclusion, emphasising the fact that un-connectedness is a prevalent factor not only on a regional level, but also on a national level. This ability to connect and move production factors efficiently depends on the size and the state of infrastructure.

The overall assessment of infrastructure in the region is not favourable. Foreign actors evaluate infrastructure as an area in which the region is poorly developed, finding that this underdevelopment bears fundamental implications on national and regional investment attractiveness. The OECD (2010) stresses that ‘currently from the investor’s point of view in the region, even the most advanced countries, the quality of transport infrastructure is dreadful and fractured with limited prevalence of motorways, and underdeveloped railway network’. According to the EBRD’s overall index for infrastructure reform, the region’s countries score between 2 and 2.5, out 4. World Competitiveness Indicators confirm these conclusions, showing that infrastructure outperforms only market size and innovation indicators.

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\(^91\) The estimated coefficients of the FTA dummy variable based on the GMM model for the region are positive and statistically significant at the 1% level of significance.

\(^92\) See Pllaha (2010): EU-Albania Stabilization and Association Agreement: Trade Integration and Economic Implications.
(earning the third spot in the list of problems). Moreover, both the World Bank (2011) and the EBRD (2011) stress that the region’s countries are at different stages of development and face different problems in terms of infrastructure. While problems extend in all aspects of infrastructure – from clean water and environment management, to electric power, telecommunications and broadband Internet penetration – it is transport infrastructure that is currently viewed as the main obstacle to investment and trade.

Resolving these problems is essential to the removal of a major obstacle that prevents the region’s strategic location and beautiful environment from materializing into much-desired and well-acknowledged comparative advantages. Infrastructure will simultaneously increase the region’s attractiveness, improve its comparative advantage in terms of market size, increase economies of scale, and support the emergence of regional economic clusters. Unfortunately, the Regional Council’s annual report concludes that ‘the whole process has been slowed down due to outstanding issues of political nature’ (2010-2011). As such, infrastructure is currently not only underdeveloped and fragmented throughout the region, but also affected by the same political factors that inhibit the overall prosperity of the region.

From a policy viewpoint, it is somehow encouraging that several obstacles carry over from one area of development to another, and originate from the same fundamental political, national or modernization dilemmas. It is remarkable, for example, to observe that the same problems of engineering and information infrastructure extend to innovation and education infrastructure. Like trade and other developments, they can benefit from regional cooperation.

Research, education and human capital

The preceding point takes the discussion to the last and probably most important factor in terms of the region’s comparative advantage: its young labour force. It constitutes a relatively abundant (and underutilized) factor, judged by the high rates of unemployment that prevail in the region. It is younger and relatively cheaper than the labour force of the EU, and yet due to the structure and sophistication of industrial production in SEE, it is fair competition for China and India, rather than for the EU labour force. Despite these perceived “advantages”, the region has lost in competition on both fronts, mostly on the grounds of productivity. This is probably the best example of a potential comparative advantage that is lost due to the low quality of one factor – in this case, the dimension of human capital.

It is widely believed that education, capacity-building and the mismatch between labour and are the main obstacles to labour productivity in the region. Detailed empirical research conducted with regard to labour market conditions, finds that the region’s efforts in capacity-building and human capital are a main obstacle to efficiency and labour force productivity.93

According to this research, in addition to other quality issues, a key concern with the structure of the education system in particular is the share of vocational education and training (VET). Statistics of school records show that total enrolment in VET differs significantly across the region, from a low of 15 per cent in Albania to 75 per cent in Bosnia Herzegovina. Despite the high rates of enrolment in professional training, which for most of the countries of the region is at par with or above the EU average, the effects in efficiency and human capital accumulation are trivial and have not provided relief for a persistently high level of unemployment in the region (in particular a strikingly high level of unemployment in the youth population).

The region also suffers from a mismatch between labour market demand (as measured by the structure of economic activity) and market supply (as measured by choices in education or the enrolment in particular programs and training profiles). Moreover, the curriculum is out-dated and needs to be adapted to the needs of today’s labour market. The OECD (2010) argues that, among other factors, the situation is a result of non-existent, or at best inadequate, relationships between industry and VET, as well as a low rate of participation in adult training.

Last but not least, the labour market is fragmented, and reflects the ethnic character of the education and training system. This problem emerges from the fact that, within states, national communities and minorities are entitled to (and do) study in their native languages. The lack of unification and certification of VET and their curricula within countries, and the region, constitutes a considerable obstacle to the emergence of a larger regional labour market and its mobility eventually fragmenting the pool of skills and human capital. This poor state of vocational training is the main obstacle in assimilation, use and adoption of technologically advanced production and manufacturing investments.

The region’s growth and investment prospects are affected not only by the particularly low level of technology adoption, but also by inadequate enrolment in and poor quality of tertiary education. Linden et al. (2008) find that tertiary education suffers in particular from low enrolment and graduation rates, poor curriculum quality, old teaching methods and skills mismatch. As a result, the supply of highly skilled workers in the region remains limited and ill-prepared to exploit the region’s comparative advantages, either through technology absorption or technology innovation.

The establishment of private universities and institutions has not enlarged the size of the highly educated labour force, or better and more adequate research and development. Instead, it has exacerbated the existing problems of quality and skills mismatch in tertiary education. The 2010-2011 Annual Report of the Regional Cooperation Council emphasises these problems, and finds that despite some achievements, problems in knowledge, education and human capital remain largely unresolved, and are potentially strong obstacles to regional development – not only from the viewpoint of EU integration and compatibility, but also from the viewpoint of overall global competitiveness.
In conclusion, the entire education, science and research system is an obstacle to the development of human capital, and thus to the establishment of competitive production capacities based on foreign direct investment.

**Conclusion**

This chapter has addressed trends and developments in foreign direct investment in the SEE region to identify the economic, political and social factors that play an important role in the size and nature of FDI. We observe that SEE is lagging behind other former transition economies in terms of the quantity and quality of foreign direct investment, despite the region’s relatively abundant endowments. This performance is the result of several historical and economic national characteristics that are commonly shared by the region’s countries. These states remain entangled in an endogenous relationship that has slowed their economic and political progress and integration process.

In principal, a comparison of costs per unit of output indicates that costs in the region are well below those in the economies of the EU and CEE. However, the region must be aware that globalization means it is also competing with China, India, Russia and other developing and emerging markets. The region is also well endowed and conveniently neighbours Europe. In this respect, SEE seems to present a favourable business proposition. However, our analysis shows that particular microeconomic inefficiencies couple with the poor quality of the labour market to undermine the region’s competitiveness.

Countries in the SEE region share particular matching economic structures and patterns of trade. These similarities offer a good opportunity to merge their economies into a single and compelling SEE market, making regional trade and economic integration an easy task. Currently, however, individual state policies are driven more by competition than cooperation and act as obstacles to economic growth, incurring microeconomic disadvantages in the context of global developments. These policies drive competition for FDI – not cooperation. Considering the current situation in a global context indicates that the region’s countries are not ready to attract foreign direct investment in the region on the needed scale.

On all these accounts, the region is much better positioned to represent itself as an integrated market, rather than as a group of single countries. From the point of view of investors, the region’s size provides scope for economies of scale. On the other hand, integration of the infrastructure, and a prioritization of infrastructure projects, will facilitate the movements of goods and services and provide scope for larger projects with regional orientation. These large projects and this larger market will build on economies of scale and economic clusters, but they require a unified infrastructure that serves the region and enhances its comparative advantages.

Based on these findings, one can summarise the agenda of requirements that corresponds to the needs of business:
• Increase the demographic and market size to provide more scope for economies of scale and efficiency.

• Create value chains across the region, to allow for a better exploitation of factors of production.

• Lay the foundations of a knowledge economy around the comparative advantages of, and to complement, the low cost of the labour force. Use academic institutions as a regional network of technological advancement and cooperation within the business community. Use the business environment as an important centre of on-the-job training and education.

• Reduce all virtual and real social, political and economic barriers by establishing a modern infrastructure to create a regional network of factors, markets, production and trade infrastructure, as well as a research and academic infrastructure that will enhance regional comparative advantages in the global economy.

Finally, our analysis demonstrates that due to current economic and administrative uncertainties surrounding the EU economies, the region’s countries must strengthen their domestic policy anchors, and even consider building regional cooperation as a strong regional anchor. The focus of the cooperation must be regional prosperity, built upon the competitiveness of SEE as a region. Such cooperation is necessary in order to increase the microeconomic appeal of regional endowments, and to reduce macroeconomic and political instability in the meantime. This will convert the entire region into a single economic area, ready to attract the attention that it deserves on the merits of its endowments.

SEE must respond to negative trends in the EU with additional efforts to make the integration process more market-oriented and attractive than the older political and institutional process. SEE must reinforce, enhance and market efficiently its comparative advantages; offer more policy coordination; and further enhance regional cooperation using CEFTA, EFSE and the Investment Compact, while encouraging other new initiatives.

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Epilogue

Peter Sanfey

As this volume goes to print (early November), the underlying purpose of the book – to define a new growth agenda for South East Europe – appears to grow ever more urgent. Almost every day brings worrying news. Signs of a sustainable recovery are hard to find anywhere. The region seems to be stuck in a situation where the normal drivers of growth – confidence, investment, credit – are all at depressed levels. The crisis in the Eurozone and the dithering and squabbling among leaders of the major EU countries are causing deep, and possibly lasting, collateral damage for SEE countries. So what can be done to help?

There are no short-term fixes for the current predicament. The problems are too deep-rooted to allow for a quick resolution. Take the state of the banking sector, for example. In many ways, the developments in this area over the past decade constitute a success story. Foreign banks, in particular, saw a growth opportunity and poured resources into the region, fuelling strong competition and large credit booms. One negative result of this is the large proportion of bad debts, or non-performing loans (NPLs), to use the more formal term – on average, around 15 per cent of total loans in SEE and about 20 per cent in a couple of cases (Albania and Serbia). Now, banks are rightly wary of extending loans to households and corporates, and levels of credit to the economy are in some countries below those of the previous year. Working through these NPL and getting them down to more acceptable levels will take time.

The scope for using short-term macroeconomic levers is also extremely limited. Currently, all governments in SEE are running fiscal deficits, and some have built up significant amounts of arrears. Only Bulgaria – long a champion of fiscal prudence in this region – looks to be in a comfortable position in this regard. At the other extreme, Serbia’s fiscal deficit has ballooned to about seven per cent of GDP and its public debt is somewhere between 55 and 60 per cent of GDP, way above the legal limit of 45 per cent of GDP. Clearly, Serbia will have to make some difficult decisions to cut back spending and raise revenues – it has already made a start in this direction in an amended 2012 budget introduced in October, although the measures taken are far from being enough to restore fiscal sustainability. But others are also likely to have to take steps to close their deficits as well, which is bound to have a dampening effect on any recovery that might emerge over the next year.
In these difficult times, it is crucial that all interested parties do not lose sight of the region’s long-term potential. In the past ten years, the Balkans has become one of the most peaceful and safe parts of the world. In time, it can also be one of the most prosperous regions anywhere. How to get there is what this volume is all about, but it will not be an easy road, as should be clear by now to all who have reached this far in the book. What will help is a more coordinated effort among the main actors – governments, the European Union and international financial institutions.

On the side of governments, it does not need to be repeated that fundamental long-term reforms are necessary across many spheres. The just-published EBRD Transition Report 2012 highlights once again the significant gaps that SEE countries must bridge to reach the standards of the most successful market economies. This EBRD report shows how little progress has actually been made in the past year, and there have even been reversals, notably in the energy sectors in Bulgaria and Romania, both of which have faced infringement action by the European Commission. Generally, however, authorities across the region seem to reaffirm their commitment to the principles of market economics and to the desirability of an enabling environment for investment and business development.

The European Union is facing so many difficulties of its own that it would not have been surprising if it had taken its eye off the South East Europe ball, so to speak. The Eurozone crisis, and the inadequate response to date, has undoubtedly damaged the Union’s credibility and role as an “anchor” for South East Europe. This damage will take some time to repair. Furthermore, the effectiveness of the anchor role was increasingly coming into question even before the economic crisis hit the region. Too much emphasis had been given in the past to top-down reforms, whereas – as argued in several chapters of this volume – it is really bottom-up support for, and implementation of, reforms that is desperately needed. Having said this, the EU continues to play a vital, constructive role in SEE. The granting of EU candidate status to Serbia, the beginning of accession talks with Montenegro, the initiation of a “High Level Dialogue” with Bosnia and Herzegovina and FYR Macedonia, and the recommendation by the European Commission that Albania be granted candidate status – all within the past year – are encouraging signs because, ultimately, South East Europe needs the full commitment of the EU if it is to achieve EU-style civil liberties and deep structural reforms in the medium to long term.

Lastly, international financial institutions (IFI) can and should step up their involvement in South East Europe, building on successful initiatives such as the Vienna Initiative, the second incarnation of which is being developed, and the IFI Joint Action Plan between the EBRD, European Investment Bank and World Bank. Talks among these institutions, as well as the IMF and EC, are under way to explore a coordinated response to the current stagnation – one that can give a much-needed boost to the region’s economies. But, just as the EU is not the only solution to the region’s problems, IFI cannot “solve” them either. Ultimately, it is up to the countries themselves to take the lead, individually and together, to restore SEE to the path of sustainable growth.
Biographies of the Editors and Contributors

Othon Anastasakis is Director of South East European Studies at Oxford (SEESOX), Director of the European Studies Centre, and a Fellow at St Antony’s College, University of Oxford. He teaches South East European politics. Previously, he was Researcher at the London School of Economics, and Expert and Advisor on European Union matters at the Greek Ministry of Foreign Affairs. He received his BA in Economics from the University of Athens, his MA in Comparative Politics and International Relations from Columbia University, New York, and his PhD in Comparative Government from the London School of Economics. His most recent books include From crisis to recovery: Sustainable growth in South East Europe (co-edited with Bastian and Watson, SEESOX 2011), In the Shadow of Europe: Greeks and Turks in the era of post-nationalism (co-edited with Nicolaidis and Oktem, Brill, 2009), and Greece in the Balkans: Memory, conflict and exchange (co-edited with Bechev and Vrousalis, Cambridge Scholars Press, 2009). He has also published many articles on comparative democratisation in South East Europe, EU-Balkan relations and EU conditionality. He is the General Editor of the Palgrave Macmillan-St Antony’s College series.

Bas B. Bakker is the chief of the Emerging Economies division in the IMF’s European Department. He was previously the mission chief for Bulgaria. He joined the Fund in 1993, and has held positions in the European, Asia Pacific, Research, and Policy Development and Review departments, working on a range of countries and policy and research issues. He has worked extensively on economic and financial vulnerabilities and crises in emerging market economies. He is the co-author of the book How emerging Europe came through the 2008-09 crisis – An Account by the staff of the IMF’s European Department, which was published in 2012. He is a national of the Netherlands, and has a PhD in economics from the University of Groningen. He is married with three children.

Boris Begović is Professor of Economics at the School of Law, University of Belgrade and the president of the Centre for Liberal-Democratic Studies (CLDS). His field of expertise includes the theory of economic growth,

**Fikret Čaušević** is Professor of Economics and International Finance at the Department of Economic Policy and Economic Theory at the School of Economics and Business, University of Sarajevo. From 2002 to 2010, he was a Visiting Fellow under the South East Europe Faculty Development Programme at the London School of Economics and Political Science. Since 2009, Fikret has been a member of the Governing Board of the Central Bank of Bosnia and Herzegovina. In the 2011-2012 academic year, Fikret was the SEESOX Alpha Bank Visiting Fellow at St Antony’s College, University of Oxford. Over the past decade, he has written extensively about economic transition in South East Europe, the Western Balkans, and Bosnia and Herzegovina. Some of his monographs and books published in English were: *Financial liberalization and globalization – Impact and effects in South East European countries*, *Money market development in Bosnia and Herzegovina*, and *Foreign trade policy and trade balance of Bosnia and Herzegovina*. His book, *Economic sovereignty and global capital flows*, was published by the International Forum Bosnia (2006), and Hyderabad University Press, India (2008). His article, ‘What type of fiscal policy for the Western Balkans during the crisis?’ was published by the Southeast European and Black Sea Studies in June 2012, and his textbook, *The Principles of Economics*, was published by the School of Economics and Business, University of Sarajevo in July 2012.

**Ardian Fullani** is the Governor of the Bank of Albania. He graduated from University of Tirana in finance and earned a second diploma in law. Upon the creation of the Bank of Albania in 1992 he became deputy governor, while also directing the international financial relations department. In 1996 Fullani left the Bank of Albania to become the managing director of the Albanian Italian Bank. In 2004 he was appointed by the Albanian parliament as the 7th Governor of the Bank of Albania. Following this appointment he promoted and implemented an institutional and administrative development leading the Bank of Albania toward the adoption of an inflation targeting regime, and a substantial legal and regulatory reform in the banking system. He was reappointed as governor in 2011. Ardian Fullani has authored and edited
several books and articles in monetary policy, financial stability, and South East European Development. He has also organized and participated in many conferences and other events in the fields of international economics and finance, central bank co-operation, and academic studies.

**Jesmin Rahman** is a senior economist at the European Department of the International Monetary Fund (IMF). In her current position, she works on emerging Europe and leads the missions to Aruba and Sint Maarten. Her research interest and publications cover current account imbalances in Europe, competitiveness, supply-chain-linked trade, exchange rate pass-through, fiscal and structural policies and the sustainable financing of development. In addition to Europe, she has worked on various countries in Asia and Africa and on policy issues affecting surveillance and program work of the IMF. Prior to joining the IMF, she worked as a consultant in the World Bank’s Middle East and North Africa region and as an Assistant Professor in the Economics Department of American University, Washington, DC. She has a BA in Government and Economics from Smith College, Massachusetts, and PhD in Economics from American University.

**Peter Sanfey**, a SEESOX associate, is Deputy Director for Country Strategy and Policy within the Office of the Chief Economist at the European Bank for Reconstruction and Development (EBRD) in London. He is responsible for the analysis of economic developments and reforms in South East Europe, and he engages in research and publications on a range of topics covering the whole transition region. He is an editor and author of the annual EBRD Transition Report. He holds a BA in Economics from Trinity College, Dublin, and a PhD in Economics from Yale University. He was a lecturer in economics at the University of Kent at Canterbury from 1992-97, teaching courses mainly in the fields of macroeconomics and labour economics, before joining the EBRD in October 1997. He has published widely in international refereed journals on a variety of topics, mostly on transition, macroeconomics and labour economics. He is also the co-author (with Christopher Cvič) of a book entitled *In search of the Balkan recovery: The Political and economic re-emergence of South-Eastern Europe*, published simultaneously in August 2010 by C. Hurst & Co. publishers (UK) and Columbia University Press (US).

**Altin Tanku** is the Director of the Research Department of the Bank of Albania. He received a Bachelor’s degree in Finance from the University of Tirana in 1993. He received a Master’s degree and a Ph.D. in Economics from the University of Wisconsin, Milwaukee in the December of 2005. His research interest covers empirical studies in monetary and international economics, as well as economic modeling. Altin Tanku has worked for the Bank of Albania in the Monetary Policy and Research Department as the Chief of the Balance of Payments Division and later as Senior Economist. After completing his PhD studies, he rejoined the Bank of Albania in the summer of 2006. He serves
as a member of Monetary Policy Implementation and Foreign Exchange Reserves Investment Committees. He is also an affiliated assistant professor of economics at New York University of Tirana, in the Business and Economics Department. He is the author and co-author of several papers focusing on monetary and international economics and economic modeling.

**Max Watson** is Director of the Political Economy of Financial Markets at the European Studies Centre of St Antony’s College, Oxford, where he also co-ordinates political-economic work on South East Europe. He is a Visiting Fellow at St Antony’s College and a Fellow of Wolfson College, Oxford. Until recently, he was a director of the Central Bank of Ireland, and also of the consultancy John Howell & Co, Ltd. between 2003 and 2007; he was adviser on financial stability to the Director General of Economic and Financial Affairs at the European Commission. Previously, he was at the IMF, where he was head of the International Capital Markets Division; a senior adviser on Europe; and later a Deputy Director of the Fund. His early career was spent at the Bank of England. His recent publications include: *From crisis to recovery: sustainable growth in South East Europe*, co-edited with Othon Anastasakis and Jens Bastian (SEESOX, 2011); “Are there Speed Limits to Real Convergence?” with Istvan Szekely, in *Real convergence in Central, Eastern and Southeastern Europe* (Palgrave Macmillan, 2009); “IMF Surveillance in Europe: Progress in Refocusing,” (IMF, July 2008); and *Laying the financial foundations for the Euro*, a book co-edited with Lars Jonung and Christoph Walkner (Palgrave Macmillan, June 2008).

**Simone Zeh** is the Regional Coordinator, South-Eastern Europe, for the Small Business Support Team at the European Bank for Reconstruction and Development (EBRD). She is currently assigned to the EBRD Resident Office in Serbia, where she oversees the implementation of the EBRD’s technical assistance programme to small- and medium-sized enterprises in the region. Previously, she worked as Economic Analyst at the EBRD headquarters in London. Simone Zeh holds an MEconSc in European Economic and Public Affairs and has been working on South East Europe since her academic studies. Miss Zeh has studied in Germany, Ireland and Slovenia, and is particularly interested in topics of private sector development and political economy.