

## **PROMISE AND PROBLEMS: THE WESTERN BALKANS FROM PROLONGED ECONOMIC TRANSITION TO EMBRACING THE EU**

**By John R. Lampe, University of Maryland, College Park**

**A more cynical subtitle for my economic accounting might be ‘From the Stability Pact for the Western Balkans to Stability Bonds for the EU’, that is, from the European Commission’s 1999 project with the World Bank to prevent further conflict in what it started calling the Western Balkans and now in 2011 forward to the Commission’s November proposal to prevent the financial collapse of the Eurozone by promoting some version of Eurobonds. The recent ups and the present downs of the past decade have made the region’s macro-economic indicators a classic moving target for our volume. But before getting to the pressing issues of the downturn, let me address the region’s longer post-conflict experience with market transitions and EU economic connections. I take the subtitle of our Chapter 8 on the economic transition *pe se*, Promise and Problems, to frame my remarks. Both promise and problems were evident in the boom years of 2004-8. Both remain relevant not only to the subsequent downturn across the region and the EU but also to the daunting post-2008 decade that lies ahead.**

Some of the economic promise remains in tact, much of it coming in tandem with the advance toward EU membership that started in 2000, building on the momentum of the Stability Pact's promise of aid for post-conflict reforms. A European Council meeting invited the then five states of the newly designated Western Balkans to pursue the EU's new Stability and Association Agreements. Progress was admittedly slow, but by 2008 only newly added Kosovo had not signed an EU agreement. Membership at least for Croatia is now on track for 2013. As for ongoing economic problems, already struggling with them across the boom years have helped the region's various political regimes to begin implementing the economic reforms now confronting the EU's southern tier before the international financial crisis descended in 2009.

But first more initial promise: Regional growth and reform served to make the prospect of meeting the EU's Copenhagen Criteria for 'a functioning market economy' seem realistic. Annual increases in Gross Domestic Product (GDP) moved up to average 5 percent for 2004-8, with only Macedonia trailing at 3 percent. Macedonia then advanced to 4 percent for 2006-8, while the rest of the region approached 6 percent. These gains went ahead despite a decline in foreign aid. Its place was taken by the Foreign

**Direct Investment (FDI) that was needed to jumpstart their market economies. By 2006-8, FDI as a percentage of Gross Domestic Product topped the aid fraction everywhere, and by a multiple of 3 to 1 in Bosnia-Herzegovina and much more in Croatia and Montenegro. Foreign banks had also swept in from Austria, Italy, Germany, France and Greece, and finally Slovenia to open up credit markets and reduce interest rates to under 10 percent. Croatia led the way with bank loans and assets that were already 70 percent of GDP by 2005. State budgets for 2005-7 showed small deficits only in Albania and Serbia.**

**Finance Ministries, attracting able locals and some receiving missions from the US Treasury Department, worked to trim budget expenditures and public debt to fractions that were less than half of GDP. Tax reforms reduced rates for individuals or enterprises, typically with some sort of flat tax, that increased revenues. So did Value Added Taxes of 15-20 percent on the standard European model, introduced all around. These fiscal reforms cut into the grey economies, especially the criminal networks from the 1990s. Central banks made major contributions as well, maintaining stable exchange rates and monitoring monetary movements. Their regular reports became the best local source of accounting and analysis for economic indicators. The**

**Croatian National Bank deserves special recognition here.**

**With the capital for capitalism in place and the concern of the original Washington Consensus over inflation assuaged, two further advantages did follow. They were the further shift of expanding foreign trade toward European Union members and the private-sector profitability of small- and medium-sized businesses (SMEs). From 1996 to 2006, the Bosnian, Croatian and Macedonian shares of exports to the EU jumped from an average of less than 50 percent to 63 percent. The growth of exports as a fraction of GDP was even more striking, increasing by as much as one half and in every case growing faster than GDP. The promise of the 2006 CEFTA agreement for free multi-lateral trade within the region could not be tested before the post-2008 downturn set in.**

**As for privatization, the major domestic priority of the original Washington consensus, small- and medium-sized enterprises provided the major success story. SMEs were 85-100 percent privatized everywhere except Bosnia-Herzegovina and everywhere led the way in growth rates and profitability. In Croatia, the SMEs accounted for two thirds of enterprise employment by 2005 and boosted the share of newly entering firms to 5 percent. For Serbia and Montenegro, the share of enterprise employment was**

less, at one half, but the pace for new firms entering was even faster thanks to new state agencies for SMEs. And all around the region, USAID and World Bank projects to provide micro-credit or otherwise encourage the SMEs have made a positive contribution.

Well, enough of these encouraging words. Now for the boom-time problems that start with foreign trade and the privatization of large-scale enterprises. Accompanying those fast rising figures for exports were even faster rising figures for imports. Only Croatia could push its export value to within four fifths of imports. The others could barely exceed one half, while Kosovo struggled to reach 10 percent. Current account deficits followed, rising by 2006-8 past 8 percent of GDP for Croatia and Albania and to 12-14 percent for Serbia, Montenegro and Bosnia-Herzegovina. As summarized in Table 8.6, these deficits were accompanied by deficits in domestic savings versus domestic investment that were larger by themselves than the combined totals for Foreign Direct Investment and foreign aid. Mention should be made of the difficulty posed by this deficit in covering the costs of pensions and health care, however reformed.

A more successful privatization of large-scale enterprises might have attracted the further FDI and expanded the exports needed to reduce these

deficits. But, as summarized in Table 8.5, the privatization of such big manufacturing firms and utilities was not only incomplete but also lagged further behind in ‘enterprise restructuring’ as judged by the EBRD. Hence the lower World Bank rankings for ‘the ease of doing business’ in Croatia despite its better standing in ‘perceived corruption’ and a lower share of its GDP in the famous ‘grey economy’, lower than the 25-30 share typical for the region (and as it turns out, for Greece and Italy as well).

Here however the problem of balancing private management and public regulation takes us beyond the focus on capital that informed the Washington Consensus of the 1990s. The focus on ‘total factor productivity’ that has informed the World bank as well as the EU since then informed the ‘Post-Washington Consensus’. Total factor productivity includes not only labor, the other classic factor of production along with land (natural resources), but also the now well established ‘residual’, the combination of social relations, educational institutions, legal framework and technological innovation that Angus Maddison’s pioneering work found to be responsible for at least one third of the remarkable growth in the West European economies in the postwar boom of 1949-73. Its role in boosting labor productivity, the key indicator for intensive versus extensive growth, was at least as important as

that of capital. And playing the central institutional role for this residual is public administration plus the rule of law that should accompany it. The addition of this public leg and the social framework that stands behind it is the second leg on which the Post-Washington Consensus stands and by which the EU has come to define ‘the functioning market economy’ required for membership.

Before turning to labor and its continuing problems in the post-2008 downturn, let me call attention to the region’s ongoing struggle to reform public administration, one that starts early in our period and also early in our volume, in Chapter 3. The progress has been halting but also recurring. It may be described in briefest terms as reducing the number of public employees and improving the training and standards of those remaining. Those standards, encouraged by World Bank and USAID grants, have made the most progress in easing the entry of a new business, the least in overcoming conflicts of interest in the judicial process. New institutes for training in public administration have not materialized and overall, the reform of public administration has not matched fiscal reform. Still, enough was achieved by 2008 to allow the EU to have concluded the aforementioned Stability and Association Agreements with all of the region’s members except the newly

**independent Kosovo.**

**For labor as well, the retraining or targeted education that all sides agree is even more needed in the post-2008 downturn has not taken place. The problem of ‘jobless growth’ was already a significant obstacle to reducing unemployment or ‘grey economy’ employment in the boom years. With birth rates falling and younger-age emigration rising since 1989, the larger number of older workers remaining have proved to be less mobile and resistant to retraining. As wages increased faster than labor productivity, the rise in employment in legal enterprises in the boom years failed to keep pace with those promising growth rates in GDP, foreign trade and foreign investment. By 2008 declining rates of unemployment were below 10 percent only for Croatia and below 20 percent only for Serbia, Montenegro and Albania. (They have gone up by 2011 but only by 2 percent). Participation rates in legal employment clustered around 40 percent of the population, far from the EU15 average of 67 percent and the EU target of 70 percent set in 2000 by its Lisbon Agenda. That target was set to address the general European problem of declining birth rates by bringing more of the existing population into the labor force.**

**For the Western Balkans, there is no quick fix for raising the**



participation rate. The only realistic way, particularly for the increasingly predominant service sector, is the longer-term process of improving higher education. Sound familiar? In addition to our own US concerns, a European university initiative, called the Bologna Process and put forward separately from the EU, has spent the past decade reaching into a number of member states and into all of the Western Balkans. The aim is to shorten and sharpen courses of study on an Anglo-American pattern directed toward job-related training. It has succeeded in some stiffening of standards and the restructuring of university administration, but student resistance to paying fees and faculty resistance to more student testing and participation have kept the Process more of a problem than a promise.

Training for management rather than labor is the one area where the various academic communities have made progress. That progress, continuing into the downturn, is training in integration economics and business education. The Economics faculties at Belgrade and Zagreb universities have raised standards and introduced business majors. The Department of Political Science in Podgorica offers a major in European integration. The business school started in Sarajevo under USAID sponsorship with the University of Delaware struggled but now survives with Turkish support. The Economics

faculty in Tirana has had an exchange agreement with the Economics Department of the University of Nebraska since 2002, while the Southeast European University in Tetovo has an overall agreement with the University of Indiana. Its business major attracts ethnic Macedonians as well as ethnic Albanians to a program taught in English and both of their languages. But there remains the question of what domestic positions are open in the post-2008 downturn to this new generation of managers. I worry that the answer may too often be the one given by the Bozidar Cerovic, the Chair of Belgrade's Economics Faculty, "The best ones leave the country".

Such unencouraging prospects take us back to the brain drain that the departures of the 1990s had already imposed on these economies. The departures have added to the difficulty of mobilizing the social transformation that is needed to create an entrepreneurial middle class and the social support for a retrained labor force. Look at international rankings for innovation, all lower around the region than those for higher education and training. Our account from Chapter 6 forward tracks the uneven progress in establishing the social framework and values that constitute along with public institutions the core of the famous 'residual' on which labor's productivity and capital's profitability must feed.

Our concluding chapter and the Epilogue we added this past Spring address the challenges that first the international financial crisis and then the continuing economic downturn have added to the post-conflict struggles of the past decade. The slow economic growth under way by Spring 2011 was yet to recover from the initial impact of the crisis. As noted in Table 9.2, merchandise exports declined in 2009 to 74 percent of their value in 2008 and imports to 78 percent. Sharper declines in imports for Croatia, Serbia and Montenegro at least reduced their current account deficits. Foreign Direct Investment fell even more to 62 percent of the 2008 level. In Serbia, the debate over how to revive FDI has led to calls for state partnership with foreign investors, as in the Fiat project already underway in Kragujevac. In her 2011 volume on *Serbia's Transition*, our former Wilson Center Public Policy Scholar Milica Uvalic called for this turn to industrial policy on the Southeast Asian pattern. Whether this approach can go beyond a few targets of opportunity in existing enterprises to attract new investors from the now struggling EU economies remains to be seen. I am more attracted to the idea of a publicly-funded new development bank, floated at a 2010 conference at Belgrade's Economics Faculty. Its low-interest lending could relieve the burdens that SMEs as well as Greenfield enterprises. They now face higher rates and

**stiffer terms from those famous foreign banks.**

**SMEs also face delayed payments on bills due from the larger enterprises they supply.**

**I can however conclude with two encouraging economic signs from a region that otherwise faces what our Epilogue calls ‘a hard bargain’ between its continuing need for international credit and domestic social support versus the austerity demanded by EU conditionality and access to IMF funding. One encouraging sign: The European banks with branches dominating the commercial finance of the Western Balkans not only pledged by the Vienna Initiative of 2009 to remain in place but had in most cases built up sufficient reserves in the branches themselves so that they could survive without additional lines of credit from the home base. Please note that this last month’s announcement from Austrian banks that their loan/deposit ratio to branches would be held at 110 percent hardly applies to Serbia and Croatia. Their ratios are barely above that level, versus others exceeding 150 percent, starting with Slovenia.**

**Second encouraging sign: The well established pathway to EU accession remains in place as a justification for austerity missing for instance in Greece and Italy. A successful Croatian accession in 2013 will add new impetus for**

**Serbia in particular. Such encouragement will nonetheless depend on the political reordering of the EU and the recovery of its member economies. It seems that another hard decade of transition lies ahead, now for Europe as well as the Western Balkans. Let us hope that US interest in seeing the EU and the region embrace each other will persevere. That is a perseverance increasingly doubted in the Western Balkans but still evident to me from the first rank of American Ambassadors and their officers who serve and seek to serve in the region. I hope that perseverance will apply to those serving in Brussels as well.**